

Sharing The Burden Of Bank Support: Countries Where Subordinated Debt Is Becoming Riskier

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Since the onset of the banking crisis in 2008, it has become increasingly evident that banks' regulatory capital instruments are becoming riskier relative to senior obligations. Many governments believe that the cost of rescuing failing banks has fallen disproportionately on taxpayers, partially as a result of an inability to allocate sufficient losses to deferrable and non-deferrable regulatory capital instruments. As governments have begun to seek ways of allocating more of the cost of future rescues to investors, we have pointed to the corresponding increase in the risk of these instruments, and have adapted our criteria and changed ratings accordingly.

Current criteria allow us to reflect such higher risk, where we see it, with the use of a lower benchmark for notching bank capital instrument ratings than the issuer credit rating (ICR) which was once the norm across our ratings universe. The lower benchmark is the stand alone credit profile (SACP), an important analytical element in our rating framework. Given that the SACP expresses our view of a bank's credit risk without external support, we believe it captures the risk inherent in moving contingent liability for bank failure from governments to investors.

For subordinated debt, however, the use of the SACP is not automatic; we need to assess whether the powers available--or expected to be available--in each jurisdiction give the authorities sufficient flexibility to inhibit the performance of subordinated debt without forcing the bank into liquidation, even if this were to conflict with its terms and conditions. If this is not the case, subordinated debt is notched from the ICR. Table 1 lists the countries where we identify a reduction in government support for subordinated debt (often referred to as lower Tier 2 debt) and where our ratings on this debt are therefore notched from our SACPs. We will continue to notch our ratings on subordinated debt issued by banks in countries that are not on this list from their issuer credit ratings (ICRs). The impact of these assessments is evident in the subordinated debt ratings disseminated as part of our roll-out of bank ratings under the revised criteria beginning on Nov. 29, 2011. In accordance with our criteria, many banks have lower SACPs than their ICRs.

Table 1

Countries In Which Government Support For Subordinated Debt Is Reducing			
Australia	France	Mexico	Switzerland
Belgium	Germany	Netherlands	United Kingdom
Canada	Ireland	Portugal	
Denmark*	Italy	Spain	

*Danish subordinated debt is deferrable in accordance with standard terms and conditions.

The Criteria In Practice

We started some time ago to distinguish in our ratings between the default probabilities of senior and subordinated debt in certain countries. The relative increase in the default probability of subordinated debt was the result of changes to banking legislation in those countries aimed at resolving failing banks at lower cost to the taxpayer. This legislation gave the authorities more flexibility to restructure failing banks with a view to preserving essential

services, while "bailing in" more regulatory capital instruments, including subordinated debt.

Accordingly, in order to reflect our opinion that subordinated debt had become riskier, we widened the notching in a number of countries. The first instance was in the U.K. in August 2009, given new banking legislation establishing a new resolution regime, and explicitly giving the authorities the ability to transfer assets and liabilities to the detriment of subordinated creditors. The U.K. authorities indeed used its powers shortly after the legislation came into effect. In October 2010 we lowered ratings on some Irish bank subordinated debt in the light of the stated intention of the Irish authorities to impose burden sharing on holders of subordinated debt of ailing banks, and of impending resolution and reorganization legislation. In February this year we lowered ratings on lower Tier 2 instruments issued by banks in Germany following a review of its Bank Reorganization Act. Under this legislation the regulator has the power to segregate all or part of an institution's assets and liabilities from a bank in crisis, and transfer these to a separate legal entity.

Under our updated criteria, we will differentiate our view of the risks in subordinated issuance between different jurisdictions during our rating process to recognize--by notching subordinated debt from banks' SACPs--the widening international moves toward greater restructuring and bail-in powers. This trend is exemplified by the work done under the auspices of the Bank for International Settlements (BIS), with the political backing of the G20, to encourage the development of resolution regimes. Further, it is evidenced by the proliferation of new or amended resolution legislation, particularly in developed banking systems where pressures on banks have been greatest.

Rationale For Determining Countries With SACP Notching

As explained in our criteria (see "Bank Hybrid Capital Methodology And Assumptions" paragraphs 73-79), we will continue to notch subordinated debt from the ICR unless "...the regulatory and legal frameworks, including bank resolution regimes, could lead to the conversion of nondeferrable subordinated debt into bail-in capital or to untimely or partial payment of coupon or principal, without provoking a legal default or the bank's liquidation." In such cases, we will notch subordinated issues which form part of a bank's regulatory capital from a bank's SACP; one notch for investment grade credits, and two for non-investment grade issuers.

This wider notching reflects our expectation that future government support built into our senior debt ratings would not, in certain jurisdictions, be available for subordinated debt, which would therefore represent a higher default risk than senior debt. The ability of a regulator to allocate losses to subordinated debt through restructuring is key to identifying jurisdictions for possible SACP notching: "Such flexibility may form part of legislation, past regulatory actions, or the statements of those authorities". Nevertheless, the ICR may still be used for countries where there are such powers, but where the use of such powers is uncertain: "In rare circumstances, a government may indicate its intention to prevent losses on nondeferrable subordinated debt" (see "Bank Hybrid Capital Methodology And Assumptions" paragraph 77).

To identify jurisdictions listed in Table 1 for SACP notching under the criteria, we focused on countries with resolution regimes or other banking legislation detrimental to subordinated debt. We see an important indicator of risk in resolution regimes to be the ability of a regulator to transfer assets and liabilities to other legal entities--such as a bridge bank, or "bad bank"--in a way which could impede the servicing of subordinated debt.

Countries Now With SACP Notching

As mentioned above, the subordinated debt of banks in the U.K., Germany, and Ireland has for some time been subject to wider notching under our criteria in consideration of the resolution legislation they had introduced. Accordingly, we believe it is appropriate for the subordinated debt of banks in these countries to be notched from the SACP under the updated criteria.

In the EU generally, the outlook is dominated by the expectation that there will be EU-wide resolution legislation at some point in the not-too-distant future. At some stage, therefore, it is envisaged that all EU countries will qualify for SACP notching, as long as the resulting framework does indeed reduce support for subordinated debt holders in the way we envisage. For now, however, individual legal provisions vary considerably. Belgium, France, Italy, the Netherlands, Portugal, and Spain are considered already to have--or to be instigating--legislation which confers restructuring powers to their respective regulators.

Switzerland is in a broadly similar position. The authorities there have so far focused substantially on contingent convertible bonds, and their bail-in properties, as important elements of bank resolution. However, restructuring powers are already quite extensive, and sufficiently extensive to support our stance on SACP notching. Indeed, it seems likely that these powers will be fortified and enhanced in forthcoming legislation.

In a further three countries the relative creditworthiness of subordinated debt is directly weakened in its terms and conditions, or by general legislation. In Australia for an instrument to qualify as lower Tier 2 capital, a default on such instruments must explicitly preclude an ability to trigger cross default on senior debt. In Canada recent guidance from the regulator expresses an expectation that all Tier 1 and 2 capital instruments "...must be able to absorb losses in a failed financial institution..." We expect differentiated treatment would apply to capital instruments and senior debt as a Canadian bank approaches a state of non-viability. Mexico has legislation which allows the authorities to enforce deferral of subordinated debt in bank resolution while maintaining the bank as a going concern.

Denmark is a special case. Subordinated debt has for a long time been deferrable in accordance with its standard terms and conditions, and our approach has always been to have wider notching and treat the issuance more like hybrid instruments.

Countries Still with ICR Notching

For all countries which are not included in Table 1, subordinated debt will be notched from the ICR. To illustrate this process, consider two major banking centers where the country designation remains one of notching from the ICR: the U.S. and Japan. In the U.S. the authorities do have strong powers to transfer assets and liabilities, but these powers kick in relatively late in the case of a bank in stress. It is therefore unlikely in our opinion that subordinated debt holders could be forcibly converted to equity in a pre-bankruptcy situation.

For Japan, while there is legislation allowing for resolution by way of a bridge bank, in our view the authorities have not stood strongly behind these provisions in practice. Traditionally, the government has commented that they would protect debt-holders, including subordinated debt holders, while during the stressful banking environment of the late 1990s and early 2000s the bridge bank option was avoided. As explained above, the provisions of paragraph 77 of our criteria on hybrid instruments allow ICR notching in such cases, because the authorities have indicated their intention to prevent losses on subordinated debt.

Future Surveillance

With momentum building internationally toward wider implementation of resolution regimes, and the fullest possible use of all types of regulatory capital, we will continue to monitor how each country reacts as part of our surveillance for Bank Industry Country Risk Assessments (BICRAs). Accordingly, we expect that we will continue to migrate countries to SACP notching from ICR notching as more resolution regimes are adopted and implemented globally.

Related Criteria And Research

Stand-Alone Credit Profiles: One Component Of A Rating, published Oct. 1, 2010

A Turbulent 2009 For European Bank Hybrids, With More Change To Come In 2010, published Feb.9, 2010

The Evolving Landscape For Banks Requires A Robust Analytical Framework, published Nov. 1, 2011

Banks: Rating Methodology And Assumptions, published Nov. 9, 2011

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Bank Resolution Regimes: Potential Rating Implications As Sovereign Support Frameworks Evolve, published March 16, 2011

Methodology For rating Bank Nondeferrable Subordinated debt (Lower Tier 2 Regulatory Capital), published Aug. 4, 2009

Ratings On German Banks' Lower Tier 2 Sub Debt Lowered Due To Bank Restructuring Act; Other Debt Ratings Not Affected, published Feb. 28, 2011

Ratings On U.K. Banks' And Building Societies' Lower Tier 2 Subordinated Debt Lowered Following Criteria Refinement, published Aug. 4, 2009

Ratings On Irish Banks' Lower Tier 2 Subordinated Debt Lowered On Reappraisal Of Authorities' Stance, published Oct. 8, 2010

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