

Credit FAQ:

Applying The Bank Hybrid Capital Criteria To Specific Instruments

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In the aftermath of the financial market crisis, regulators and market participants have been considering new types of hybrid capital instruments that banks may issue in the future. While the exact features of these new instruments are still to be determined by the issuing banks, Standard & Poor's Ratings Services has examined some of the potential structures in light of its new criteria "Bank Hybrid Capital Methodology And Assumptions" published on Nov. 1, 2011.

We are publishing this report to answer questions about how we would likely apply our new criteria to these potential instrument structures, including the contingent capital structure proposed by the European Banking Authority (EBA).

Frequently Asked Questions

The bank hybrid capital criteria differentiate between instruments with "going-concern" triggers and those with "nonviability" triggers. What level of regulatory capital do you associate with a "going-concern" trigger and how does this relate to the Basel III conditions?

The criteria do not define specific regulatory capital ratio levels that automatically identify a trigger attached to a bank's hybrid capital instrument as a "going-concern trigger" or as a "nonviability" trigger. (The definitions of "going-concern" and "nonviability" are in paragraphs 34-37 of "Bank Hybrid Capital Methodology And Assumptions".) The reason for this is that in our view a specific capital ratio level alone does not always determine whether a bank is nonviable or still operating as a going concern. We believe that other factors, including liquidity, contribute to this determination and, in addition, regulatory capital ratios are not directly comparable across all markets and banks. This means that although two banks may have the same capital ratio level, one bank could be considered nonviable, whereas the other might still be regarded as a going concern.

Several market participants have asked how we would typically treat an instrument with a mandatory conversion or write-down trigger set at a regulatory common equity Tier 1 ratio (a ratio that excludes hybrids) of 5.125%. This figure is the minimum level at which--under Basel III--additional Tier 1 capital instruments must convert into common shares or undergo a principal write-down. Such a capital position would typically represent a "nonviability" situation for many banks under Basel III, in our view.

We would therefore tend to treat a mandatory trigger linked to a regulatory common equity Tier 1 ratio of 5.125% or lower as a "nonviability" trigger (although exceptions may apply in some markets). The reason for this is that Basel III requirements and market expectations will likely require many banks to operate with significantly higher capital than a common equity Tier 1 ratio of 5.125% implies. We expect that because of this many banks would likely experience a weakening of market confidence once their capital ratios move toward this level. We also note that 5.125% is at the bottom range of the proposed capital conservation buffer under Basel III and would correspond to a point at which a bank would not be allowed to distribute any earnings. We believe a bank would likely be subject to significant regulatory monitoring before it reaches this level of regulatory capital.

Under our criteria, "nonviability" triggers include the Basel III feature allowing a hybrid capital instrument to

qualify as regulatory capital if it would be written off or converted into common equity upon an event that regulators determine would cause the issuer to become nonviable absent a write-off of the instrument or public support.

We would tend to treat triggers linked to a common equity Tier 1 ratio of 7% or higher as "going-concern" triggers. For ratios between 5.125% and 7%, we would typically treat triggers linked to ratios close to 5.125% as "nonviability" triggers and those linked to higher ratios as "going-concern" triggers.

How would you treat a contingent capital instrument, under the criteria, that conforms to the indicative term sheet published by the EBA?

On Dec. 8, 2011, the EBA published a draft common term sheet for contingent capital instruments called buffer convertible capital securities (BCCS) that would be eligible for inclusion in Tier 1 regulatory capital. The common term sheet sets out the EBA's minimum requirements for such an instrument, although actual instruments issued by a bank may have additional or different features.

Under our criteria, a hybrid capital instrument with the proposed BCCS structure would be eligible for our "intermediate" equity content category, the highest level available for "going-concern" contingent capital. However, our assessment of a specific instrument would depend on: (i) the degree to which the features of such an instrument conform to those in the common term sheet and (ii) any other relevant bank-specific factors. "Intermediate" equity content applies because, according to the common term sheet:

- BCCS would be perpetual and have no features offering an incentive to redeem.
- Coupon payment dates for BCCS must be aligned with dividend payment dates. This means there are unlikely to be look-back features that disqualify such an instrument from the "intermediate" equity content category, under the criteria in "Assumptions: Clarification Of The Equity Content Categories Used For Bank And Insurance Hybrids With Restricted Ability To Defer Payments," published Feb. 9, 2010.
- The capacity to stop paying coupons would be consistent with the ability to absorb losses on a "going-concern" basis as defined in our bank hybrid capital criteria.
- The core Tier 1 ratio contingency event would likely count as a "going-concern" contingent capital clause under our criteria. This clause leads to mandatory conversion of the instrument into common equity if the core Tier 1 ratio falls below 7%.

BCCS would contain a viability event clause that mandatorily requires conversion into common equity if the regulator deems the issuing bank to be nonviable. Under our criteria, this clause would count as a nonviability contingent capital clause, but the instrument would still qualify for the "intermediate" equity content category based on the features outlined above.

The EBA foresees replacing the core Tier 1 ratio contingency event with a common Tier 1 ratio contingency event after removing the requirement that banks achieve a core Tier 1 ratio of 9%. Once the common Tier 1 ratio contingency event goes into effect (at some point after Jan. 1, 2013), mandatory conversion into common equity would occur if a bank's common Tier 1 ratio fell below 5.125%.

The trigger levels under the two ratios are not fully comparable because the ratio definitions differ. However, we would expect to treat a clause linked to the 5.125% common Tier 1 ratio as a "nonviability" trigger. After the common Tier 1 ratio contingency event goes into effect, a BCCS instrument's inclusion in the "intermediate equity content" category would depend on the ability to stop paying coupons.

To assign an issue rating to a BCCS instrument, we would use Table 3a of "Bank Hybrid Capital Methodology And Assumptions," published Nov. 1, 2011. However, Table 3a does not apply and the issue rating is capped at 'CCC' if the issuing bank's data do not facilitate monitoring of the regulatory capital ratio linked to the trigger (see paragraph 71 of the criteria).

How do you treat an instrument that contains "going-concern" triggers as well as "nonviability" contingent capital triggers?

The issue rating on a hybrid capital instrument reflects our opinion of the likelihood that it will absorb losses and that a "going-concern" trigger will generally be activated before a "nonviability" trigger. A capital ratio trigger would not typically capture factors such as liquidity, which could contribute to "nonviability". Nonetheless, our assessment of the issuer's stand-alone credit profile (SACP) shows our opinion of how close an issuing bank is to "nonviability".

The criteria address "nonviability" contingent capital (NVCC) triggers in Step 2b of Table 2, which requires a deduction of one notch from the indicative issue rating. Tables 3a and 3b are only used if a hybrid capital instrument contains a mandatory "going-concern" trigger defined as a specific capital ratio number.

If a hybrid capital instrument contains a "going-concern" contingent capital trigger, expressed as a capital ratio number, then we use Table 3a. However, as stated in the third bullet point of paragraph 69 of the criteria, the issue rating we assign is the lower of the outcome using Table 2 or the rating cap indicated in Table 3a or Table 3b. This means that if the instrument also contains an NVCC clause, we are unlikely to need Step 2b from Table 2, since the rating outcome under Table 3a would usually still be the lower than the outcome if Table 2 had been used. If the rating outcome under Table 2 is lower than that using Table 3a, then we use the outcome under Table 2.

If a hybrid capital instrument contains a mandatory coupon-nonpayment clause (not a contingent capital clause) linked to a trigger expressed as a specific regulatory capital ratio number, then we use Table 3b. If the instrument also contains an NVCC clause, then we consider whether the rating outcome would have been lower using only Table 2. We apply the lower rating outcome from Table 2 or Table 3b. Note that the issue ratings in Table 3b are lower at weaker SACP levels and as the buffer over the regulatory capital trigger declines. This means the rating using Table 3b is often lower than would have been the case under Table 2.

If an instrument contains multiple contingent capital clauses linked to different regulatory capital ratios, the issue rating is based on the first trigger that would be activated. Upon activation of this trigger, the issue rating would be lowered to 'C' (see Step 5 of Table 2). If an instrument subsequently undergoes an additional write-down of principal, there is no additional rating action because the issue rating will already be at 'C'. If the loss absorption is not in line with the terms and conditions of the instrument, then we assign an issue rating of 'D'.

Could you provide examples of the types of situations referred to in paragraph 69 that could lead to the deduction of an additional notch during the rating process?

The deduction of an additional notch is applicable whenever we see that the contractual terms of an instrument only allow the issuer to pay the coupon from current-year earnings, as is the case for certain instruments issued in Australia and Spain. Additional notches reflect our view on heightened risk of an annual loss and can apply even if regulators have in the past allowed financial institutions to pay coupons if current-year earnings were insufficient.

Furthermore, additional notching reflects our view of an increasing tendency for regulators to expect such hybrid instruments to act as capital (i.e. to not pay if the issuer has made a loss) if classified as regulatory capital. This is

particularly in light of developments during and after the global financial market crisis.

Other situations leading to additional notches may arise from the results of statutory tests, including those leading to mandatory nonpayment if the bank does not have sufficient distributable reserves. We deduct at least one additional notch in situations where we see a risk of insufficient earnings and reserves to allow coupon payments.

We would not typically deduct an additional notch for such a situation if a bank's distributable reserves are high, but if we saw a risk of a depletion of the distributable reserves that is not reflected in the SACP. Low distributable reserves often lead to a weak SACP, but in some situations subsequent capital injections boost nondistributable reserves and, in turn, the SACP, even though distributable reserves remain low.

Another possible scenario involves the authorities prohibiting coupon payments following a loss or stress situation. An example is if the European Commission required a bank to stop coupon payments on hybrid capital after ruling that the bank had received state aid. In such a situation, we may deduct additional notches to reflect the risk that the bank's financial position could lead to a state aid ruling that could prevent coupon payments on hybrid capital, but only to the extent that this risk is not otherwise reflected in the SACP.

Tables 3A and 3B show how you treat instruments with a trigger defined as a specific regulatory capital ratio expressed as a number. What about other potential triggers?

In paragraph 72 of the criteria, we discuss several triggers that would lead to a 'CCC' cap on an issue rating. Additional types of triggers may emerge in the market in the future. We do not, however, comment on hypothetical triggers.

How do you distinguish between a nondeferrable subordinated debt instrument that has NVCC status due to a statutory ruling, as opposed to one that contains an NVCC clause?

Section C.3 of the criteria details the rating of traditional nondeferrable subordinated debt instruments.

If such an instrument contains a contractual mandatory NVCC clause, then we consider it a hybrid capital instrument for the purpose of assigning an issue rating, which is derived by notching from the SACP using Table 2. The rating is subject to Step 2b of Table 2 and the second bullet point of paragraph 69 of Section C.2 of the criteria. Statutory NVCC clauses could also be mandatory and not allow the bank any discretion, and we would address this in the same way using Table 2.

The minimum notching (shown in paragraph 63) that we apply at the start of our rating analysis would only reflect deductions for subordination and no deduction for partial or untimely payment. This is because nondeferrable subordinated debt instruments typically do not have a coupon nonpayment clause. This means, for example, that a nondeferrable subordinated debt instrument with a mandatory NVCC clause, issued by a bank with an SACP of 'bbb', would be rated 'BB+' (i.e. two notches below the SACP).

Legislation could allow a bank or regulator the option of treating a hybrid capital instrument as contingent capital, meaning that conversion or a write-down of principal is optional. If this is the case, we would use notching from the SACP as described in Section C.3 in our rating analysis. If a statutory ruling introduces a mandatory NVCC clause, then the rating approach from the previous paragraph is used.

If a nondeferrable subordinated debt instrument contains a contractual optional NVCC clause, the rating approach is to notch down from the SACP, regardless of the jurisdiction.

What happens if the rating on a bank's nondeferrable subordinated debt is based on notching from the SACP, due to the legal framework in its jurisdiction, but the bank's subsidiary issues a similar instrument in a country for which the rating approach is to notch from the issuer credit rating?

If a bank subsidiary benefits from group support, we cap the rating on a hybrid capital instrument issued by that subsidiary at no higher than, but potentially lower than, the issue rating on the parent bank's hybrid instruments (see the third bullet point of paragraph 58 of the criteria). The rating cap refers to equivalent types of hybrid capital instruments. For example, the cap relates to the issue rating that would have applied if the hybrid capital instrument had been issued by the parent.

We use this approach unless the issuer credit rating on the subsidiary is higher than that on the parent (see Subpart E of "Group Rating Methodology And Assumptions," published Nov. 9, 2011). We consider that restrictions on a parent bank's ability to pay its own nondeferrable subordinated debt are likely to affect its ability to support nondeferrable subordinated debt issued by subsidiaries.

How do you treat bank hybrid capital instruments issued by a "highly strategic" or "moderately strategic" subsidiary?

The definitions of subsidiaries classified as "highly strategic" and "moderately strategic" were introduced in "Group Rating Methodology And Assumptions," published on Nov. 9, 2011. The category "highly strategic" applies to subsidiaries we classify between "core" and "strategically important". The category "moderately strategic" refers to subsidiaries that we expect to receive less support than those classified as "strategically important".

The treatment of bank hybrid capital instruments issued by "highly strategic" subsidiaries is covered in paragraph 58 of "Bank Hybrid Capital Methodology And Assumptions," published Nov. 1, 2011.

"Moderately strategic" subsidiaries are not covered by paragraph 58.

How do you treat exchange offers on a bank's hybrid capital instruments and nondeferrable subordinated debt?

Our criteria for rating instruments subject to exchange offers are in "Rating Implications Of Exchange Offers And Similar Restructurings, Update," published May 12, 2009. That article discusses two conditions that lead us to consider certain exchange offers to be tantamount to a default under our criteria. These conditions are that we believe the offer:

- Implies the investor will receive less value than the promise of the original securities; and
- Arises from the issuer's distress and is not purely opportunistic.

In question 14 of the May 12th article, we discuss the treatment of hybrids. An exchange offer on a hybrid capital instrument may reflect the possibility that, absent the exchange offer taking place, the issuer would exercise its option to defer coupons or otherwise not service the instrument. If we classify an exchange offer as distressed, we lower the issue rating on the bank hybrid capital instrument to 'C' (see Steps 4 and 5 of Table 2 of "Bank Hybrid Capital Methodology And Assumptions," published Nov. 1, 2011). We lower the rating to 'D' if we see that the offer clearly results in a greater reduction in value than would have resulted from loss absorption under the terms of the instrument, including a deferral.

If the issuer has an SACP of 'bb-' or higher, we would not ordinarily characterize an exchange offer as a de facto restructuring. If the SACP is 'b-' or lower, we would typically view an exchange offer as distressed. If the SACP is 'b+' or 'b', market prices or other cues would determine whether we classify the offer as distressed.

We also consider any specific terms attached to an instrument that may make nonpayment more likely than suggested by the SACP (i.e. features that lead to additional notching under paragraph 69 of the bank hybrid capital criteria).

RELATED CRITERIA AND RESEARCH

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

- **Sharing The Burden Of Bank Support: Countries Where Subordinated Debt Is Becoming Riskier**, Nov. 29, 2011
- **Banks: Rating Methodology And Assumptions**, Nov. 9, 2011
- **Group Rating Methodology And Assumptions**, Nov. 9, 2011
- **Bank Hybrid Capital Methodology And Assumptions**, Nov. 1, 2011
- **Assumptions: Clarification Of The Equity Content Categories Used For Bank And Insurance Hybrids With Restricted Ability To Defer Payments**, Feb. 9, 2010
- **Rating Implications Of Exchange Offers And Similar Restructurings**, Update, May 12, 2009

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