Ratings

CRISIL
An S&P Global Company

Rating criteria for Basel III-compliant non-equity capital instruments

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Executive summary

Basel III regulations are designed to enhance the quality and quantity of capital held by banks. Basel III bonds have both higher capital requirement and loss-absorption features compared with Basel II. Therefore, CRISIL's rating criteria on these instruments incorporate the additional risks investors face. These risks are full coupon discretion and high capital threshold for likely coupon non-payment; sufficiency of profits, and caveats on use of revenue reserves and other eligible reserves for coupon payments. Hence, the ratings on these instruments would be lower than the Corporate Credit Rating (CCR) of banks in a vast majority of cases. Tier II ratings under Basel III would be the same or close to the bank's CCR as there is no significant impact of the additional features.

Scope

This document outlines the criteria for rating non-equity Tier I and Tier II instruments, which comply with Basel III norms as prescribed by the Reserve Bank of India (RBI). These criteria incorporate the changes the RBI has announced in its September 1, 2014[1] and February 2, 2017 guidelines pertaining to these instruments. *Please refer to the Annexure for a summary of changes in the RBI guidelines.*

Overview of Basel III norms in India

The RBI's regulations envisage the full implementation of Basel III capital requirements by March 31, 2019. The regulations are designed to enhance the quality and quantity of capital held by banks. The following table compares the capital requirements under Basel III (after full implementation) and Basel II.

Percentage of risk-weighted assets	Basel III	Basel II
Equity capital ratio (A)	5.5%	3.6%
Capital conservation buffer (B)	2.5%	-
Total equity capital ratio (C=A+B)	8.0%	3.6%
Non-equity Tier I capital ratio (D)	1.5%	2.4%
Total Tier I capital ratio (E= C+D)	9.5%	6.0%
Tier II capital ratio (F)	2.0%	3.0%
Total capital ratio (E+F)	11.5%	9.0%

As opposed to non-equity instruments qualifying as Tier I capital under Basel II, such instruments under Basel III have increased capital requirements and higher loss-absorption features. They have coupon discretion at all points in time, high capital thresholds for coupon non-payment, and principal-loss absorption clauses which distinguish them from Tier I instruments issued under Basel II regulations. Tier II instruments issued under Basel III can be written down at the point of non-viability (PONV). In contrast, there is no principal write-down feature for instruments issued under Basel II regulations.

[1] Refer the following link for accessing the previous published rating criteria (https://www.crisil.com/Ratings/Brochureware/RR_ASSES/BASEL_III_compliant_instruments_version.pdf)

CRISIL's rating criteria incorporate the additional risks to the investor arising from these features.

The box below gives a summary of the key features of Basel III-compliant Tier I instruments.

Key features of Basel III-Compliant Tier I Instruments

The following are the key risks in Basel III Tier I bonds:

1. **Existence of full coupon discretion**: In Tier I instruments issued under Basel III, banks have coupon discretion at all points of time. However, CRISIL does not expect banks to exercise discretion in the normal course of business, but only if capital falls below the regulatory threshold. Exercising this feature when the bank has the ability to make the payment (no regulatory restriction) is likely to be viewed negatively by investors and will make the future raising of non-equity capital extremely challenging for the bank.

2. **High thresholds for likely coupon non-payment:** The thresholds for coupon non-payment are higher for Basel III Tier I instruments compared with instruments issued under Basel II and Tier II instruments under Basel III. Coupon non-payment can occur in one of the following two cases:

   a) **Core equity capital falls below the threshold of 8%:** The likelihood of coupon non-payment increases significantly. The coupons and dividends that can be paid below a core equity capital of 8% are governed by a capital conservation framework as mentioned in the following table:

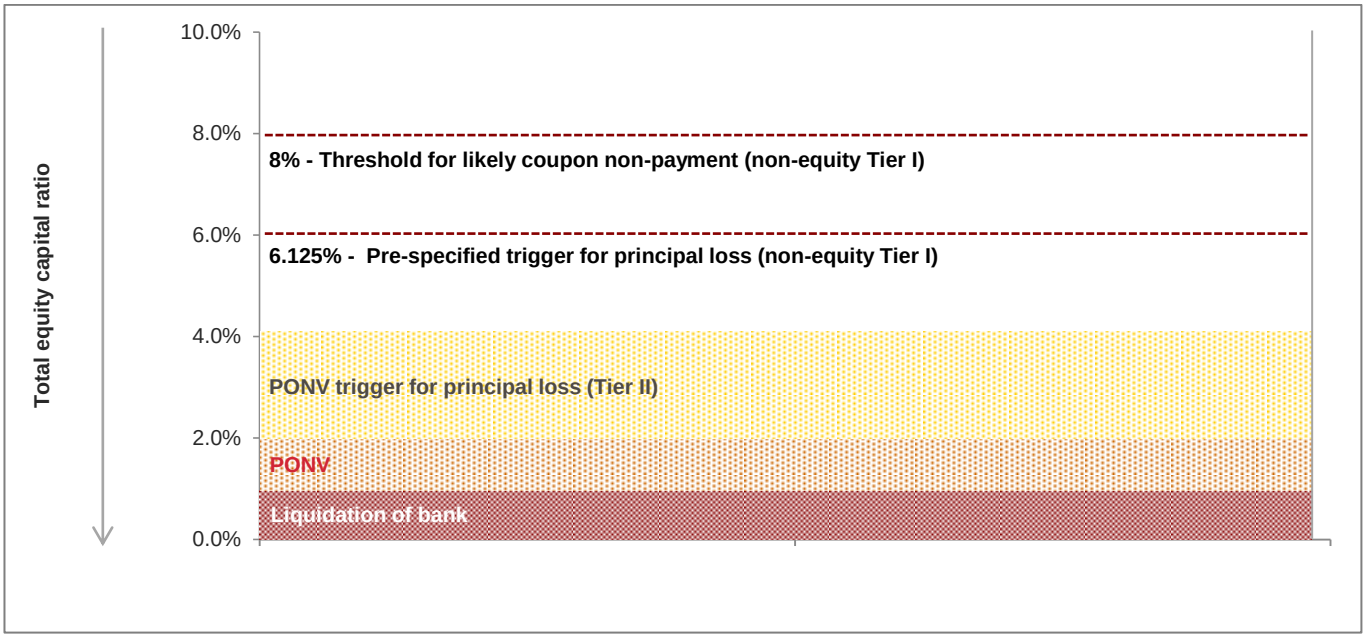
Common equity Tier I ratio after including current period retained earnings	Minimum capital conservation ratios (as a percentage of earnings)
5.5% - 6.125%	100%
6.125% - 6.75%	80%
6.75% - 7.375%	60%
7.375% - 8.0%	40%
> 8.0%	0%

   For example, at a core equity capital of 7.375 to 8%, banks can pay coupon and dividends only to the extent of 60% (=100-40) of earnings, while at a core equity capital of 6.125 to 6.75%, banks can pay only 20% of earnings as coupon.

   b) **Banks make a full-year loss and have insufficient free reserves to pay coupon:** While earlier regulations allowed banks to pay coupon only out of the current year's profits and revenue reserves, the RBI regulations of February 2017 allow other reserves, including statutory reserves, for coupon payment. Since the quantum of reserves available with banks to service coupon increases as a result, it significantly reduces the risk of non-servicing of coupon. The bank's ability to maintain sufficient free reserves to pay coupon would be a critical factor.

3. **Principal-loss absorption:** Instruments issued under Basel III have principal-loss absorption. In Tier I instruments, this feature will cause principal write-down or conversion to equity on breach of a pre-specified trigger (6.125%). While the RBI's earlier guidelines made it mandatory for the write-down to be permanent, banks can opt for temporary write-down under the September 2014 guidelines, thus reducing the risks for investors. However, at the point of non-viability, the instruments have to be permanently written down, as is the case with Tier II instruments issued under Basel III capital regulations (*refer to chart below*).

Stringent capital thresholds for Tier I instruments issued under Basel III



Note – The PONV and PONV trigger depicted in the above chart is only for the purpose of illustration.
These thresholds have not been quantified specifically by regulation.

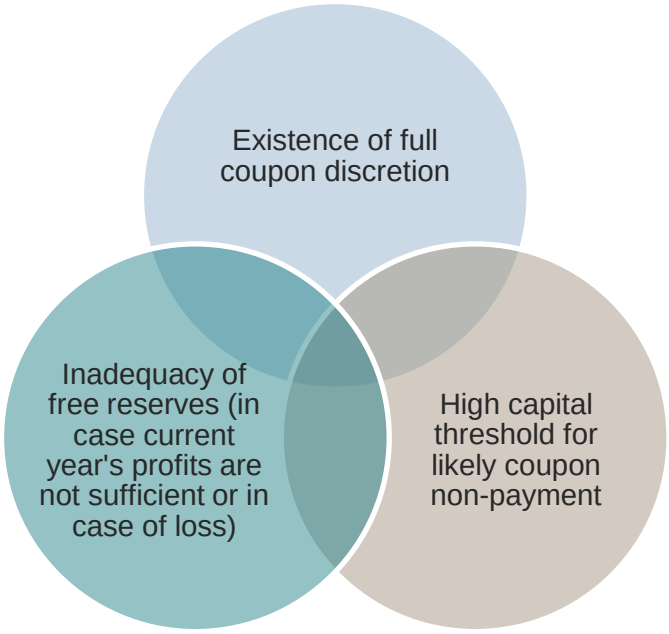
RBI's revised guidelines on adequacy of reserves

Earlier regulations allowed banks to pay coupon only out of the current year's profits and revenue reserves. Under revised RBI regulations in February 2017, banks can also tap into other reserves, including statutory reserves, for coupon payment (adjusted for any accumulated losses). However, the share premium, revaluation reserves, foreign currency translation reserves, investment reserves, and reserves created on amalgamation are not allowed to be used for coupon payment. This has reduced the risk of non-servicing of coupon on Tier I bonds as the quantum of reserves available with banks to service coupon has increased significantly.

Rating criteria for Basel III-compliant instruments

Tier I instruments

In addition to the parameters under the CRAMEL[1] framework, from a credit risk perspective, CRISIL's criteria for Basel III-compliant Tier I instruments take into account the following key risk factors:



Tier I instruments under Basel II didn't have these features.

Refer to the table below for a comparison of features under Basel II and III regulations.

Features	Basel II-compliant Tier I instruments	Basel III-compliant Tier I instruments
Coupon discretion	Banks not liable to make interest payments on these instruments if they were in breach of the minimum regulatory capital adequacy ratio (9%).	Banks have the discretion to cancel distribution/payments at all times
Coupon servicing on posting loss	RBI permission required for coupon payment if bank reports a loss.	Coupon payment can be made out of eligible reserves from appropriations of net profits (adjusted for any accumulated losses), if current year profits are not sufficient or in case of loss (provided the bank meets all other regulatory capital requirements)
Capital threshold at which risk of non-servicing increases	Breach of the minimum regulatory capital adequacy ratio (Tier I + Tier II of 9%).	Breach of minimum common equity Tier I (CET I) capital requirement (8%) at which capital conservation would kick-in which can result in coupon non-payment

CRISIL believes these factors make Tier have instruments under Basel III riskier than those under Basel II. Hence, CRISIL would typically rate a bank's Basel III-compliant Tier I instrument lower than the bank's CCR. The number of notches will depend on the following two dimensions: i) reserves (adjusted for any medium-term stress in profitability) and ii) cushion over regulatory minimum CET1 (including CCB) capital ratios. CRISIL would also evaluate the bank's demonstrated track record and management philosophy regarding maintaining sufficient CET1 capital cushion above the minimum regulatory requirements.

CRISIL would typically rate a bank's Basel III-compliant Tier I instrument one to three notches lower than the bank's CCR. On an exception basis, CRISIL may also assign a rating that is different from the notches mentioned. In case of an exception, in addition to strong comfort on the above dimensions, banks will also have to additionally display significant scale and play a special or systemic role in the Indian banking/ financial sector.

If the bank's metrics are weak enough to merit it, CRISIL will look at notch-down from CCR of more than three notches on a case-by-case basis.

To summarise, CRISIL will consider the following factors while arriving at its ratings on Tier I instruments under Basel III:

- The overall credit risk profile of the bank (reflected in the bank's CCR/the rating assigned to its lower Tier II bonds under BASEL II)
- Adequacy of the eligible reserves to service coupon after adjusting for any medium-term impact of profitability on the bank's reserves position in a stress scenario.
- The cushion that a bank will maintain in its CET1 (including CCB) on a steady state basis over the minimum regulatory CET1 (including CCB) ratio prescribed by RBI.
- The management philosophy regarding, and demonstrated track record of, maintaining sufficient CET1 capital cushion above the minimum regulatory requirement.

Tier II instruments

Basel III-compliant Tier II capital instruments have additional features which distinguish them from such instruments under Basel II.

The key distinguishing feature is the PONV trigger, the occurrence of which may result in loss of principal to the investor and hence to a default on the instrument. However, CRISIL believes that the PONV trigger is a remote possibility in the Indian context—a robust regulatory and supervisory framework and the systemic importance of the banking sector are expected to ensure adequate and timely intervention by RBI to avoid a situation wherein a bank becomes non-viable. The inherent risk associated with the PONV feature is adequately factored in the bank's CCR.

Hence, CRISIL's rating on Basel III-compliant Tier II capital instruments could be the same or one notch lower than the CCR of the bank.

Conclusion

Recognising the unique credit risk characteristics of Basel III-compliant non-equity capital instruments, CRISIL has designed tailor-made criteria to assess their credit quality. CRISIL views the high capital threshold of CET I of 8% and availability of coupon discretion, coupled with the inadequacy of eligible reserves to meet coupon payments, as the key risk factors in Tier I instruments. Under the previous published criteria for rating Tier I bonds, given the equity-like features of these bonds, CRISIL would typically rate banks' AT1 Bonds two notches lower than the bank's CCR with higher notch downs considered if bank's credit metrics were weak enough to merit that. As of March 31st, 2017 a number of CRISIL rated AT1 Bonds were three notches lower than the bank's CCR.

After the relaxation in the RBI's guidelines, the quantum of reserves available with banks to service coupon has increased significantly, lowering the scope of notch-down implied earlier. Hence, under the new guidelines, CRISIL would typically rate a bank's Basel III-compliant Tier I instrument between one and three notches lower than the bank's CCR. Notch-down of more than three notches from CCR will be considered if the bank's credit metrics are weak enough to merit that.

The notch-down for AT1 Bonds will usually be at least one notch in all circumstances. Any deviation from the same will additionally take into account the bank's scale, special role, or systemic importance.

There is no significant impact of additional features in Basel III-compliant Tier II instruments vis-a-vis Basel II. Hence, the ratings on such instruments under Basel III would be the same or close to the bank's CCR.

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