

Rating criteria for Basel-III non-equity instruments

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Executive summary

Basel III regulations are designed to enhance the quality and quantity of capital held by banks and hence Basel III instruments have higher loss-absorption features compared with Basel II instruments. Therefore, CRISIL Ratings' criteria on these instruments incorporate the additional risks that investors face. For AT I instruments, 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 typically be lower than the corporate credit rating (CCR) of banks. On the other hand, Tier II ratings under Basel III would be the same or close to the bank's CCR as there is no significant credit quality impact of the additional features in these instruments.

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)¹.

Overview of Basel III norms in India

Basel III capital requirements have been fully implemented since October 1, 2021. The regulations are designed to enhance the quality and quantity of capital held by banks. The following table provides the capital requirements under Basel III (before and after full implementation).

| Percentage of risk-weighted assets | Basel III (Until October 1, 2021) | Basel III (After October 1, 2021) |
|--|--------------------------------------|--------------------------------------|
| Equity capital ratio (A) | 5.5% | 5.5% |
| Capital conservation buffer (CCB) (B) | 1.875% | 2.5% |
| Total equity capital ratio (C=A+B) incl. CCB | 7.375% | 8.0% |
| Permissible non-equity Tier I capital ratio (D) | 1.5% | 1.5% |
| Total Tier I capital ratio (E=A+D) excl. CCB | 7.0% | 7.0% |
| Tier II capital ratio (F) | 2.0% | 2.0% |
| Total capital ratio (C+D+F) incl. CCB | 10.875% | 11.5% |

As opposed to non-equity instruments qualifying as Tier I capital under Basel II, instruments under Basel III have 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 that 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.

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

¹ Refer the following link for accessing the previous published rating criteria

https://www.crisilratings.com/content/dam/crisil/criteria_methodology/financials/archive/rating-criteria-for-basel-III-compliant-non-equity-capital-instruments-april2020.pdf

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

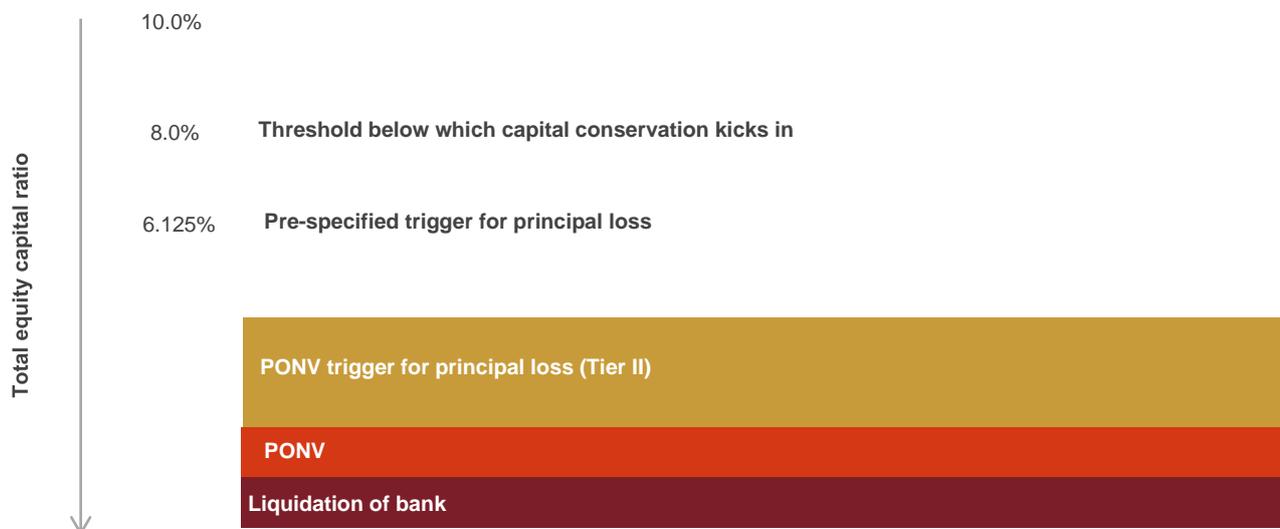
Key features of Basel III Tier I bonds

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 Ratings does not expect banks to exercise discretion in the normal course of business, unless the adjusted eligible reserves are insufficient or capital falls below the regulatory threshold. Exercising this feature when the bank has the ability to make the payment 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 8.0%:** The likelihood of coupon non-payment increases significantly. The coupons and dividends that can be paid below a core equity capital of 8.0% are governed by a capital conservation framework as mentioned in the following table:

| CET1 (inclusive of capital conservation buffer [CCB]) | % of capital conservation |
|---|---------------------------|
| 5.50-6.125% | 100% |
| 6.125-6.75% | 80% |
| 6.75-7.375% | 60% |
| 7.375-8.0% | 40% |
| >8.0% | 0% |

- 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 profit 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 into equity on breach of a pre-specified trigger (6.125%) or when PONV is reached. In such a case, 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*). However, when relevant authorities reconstitute or amalgamate a bank with another bank, such a bank shall be deemed as non-viable or approaching non-viability. Under such a scenario, both the pre-specified trigger and PONV shall apply as per Section 45 of the Banking Regulation Act, 1949. Accordingly, AT1 bonds shall be converted into equity or written down permanently before such reconstitution or amalgamation, in accordance with the rules.

Stringent capital thresholds for Basel III Tier I instruments



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

Evolution of RBI's guidelines on adequacy of reserves

Earlier regulations allowed banks to pay coupon only out of the current year's profit and revenue reserves. As per RBI regulations, banks can also tap into other reserves, including statutory reserves, for coupon payment (adjusted for any accumulated losses). 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. However, share premium, revaluation reserves, foreign currency translation reserves, investment reserves, and reserves created on amalgamation are not allowed to be used for coupon payment.

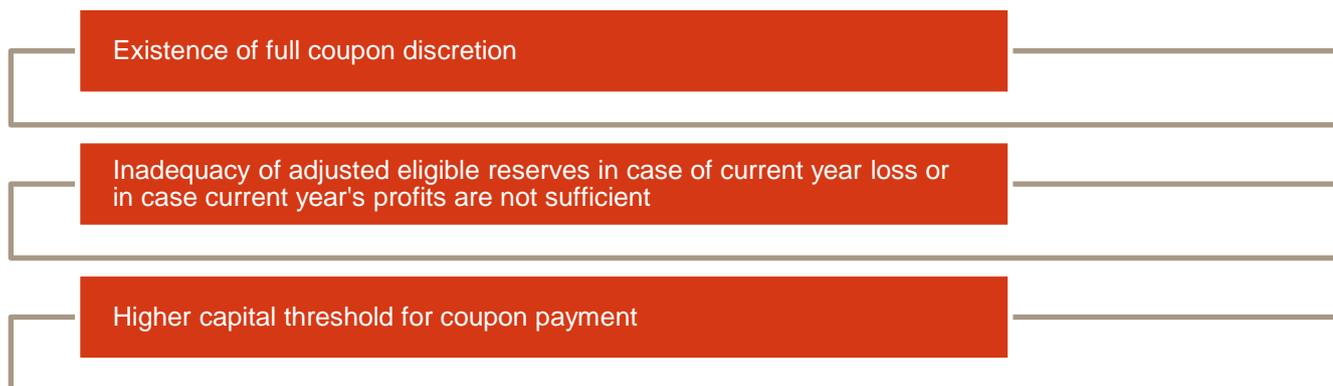
Rating criteria for Basel III instruments

Additional Tier I (AT1) instruments

In line with CRISIL Ratings' criteria, following are the instances when default is recognised for Basel III AT1 instruments:

- Coupon payment is skipped
- Conversion into equity or write-down/off or when PONV is declared

In addition to the parameters under its bank rating framework, from a credit risk perspective, CRISIL Ratings' criteria for Basel III-compliant Tier I instruments take into account the following key risk factors:



Refer to the table below for the differences between Basel III AT1 and Basel II Tier 1 instruments

| Features | Basel II Tier I bonds | Basel III AT1 bonds |
|---|---|--|
| Coupon discretion | Banks not liable to make interest payments on these instruments if they were in breach of the minimum regulatory capital adequacy ratio | 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 adjusted 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) | Breach of minimum common equity Tier I (CET1) capital requirement (8.0%) at which capital conservation would kick in, which can result in coupon non-payment |

CRISIL Ratings believes these factors make Basel III AT1 instruments riskier than Basel II Tier I instruments.

CRISIL Ratings would typically rate a bank's Basel III AT1 instrument lower than the bank's CCR. This would correspond to CRISIL Ratings assigning the Basel III AT1 instrument 1-3 notches lower rating than the rating on the bank's Basel III Tier II instruments. It is worth noting that the notch-down may be higher for a weak bank, and that the gap may widen when a bank's credit metrics are deteriorating. This implies that the floor is not restricted to 3 and can increase as the bank's CCR goes down. This is because for weak banks, or those less viable ones, these instruments start behaving more like equity and less like debt.

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, and bank's track record and philosophy in maintaining the same

To summarise, CRISIL Ratings will consider the following factors while arriving at its ratings on AT1 instruments under Basel III:

- The overall credit risk profile of the bank (reflected in the bank's CCR)
- 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 and the management's 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 that 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, in a default on the instrument. However, CRISIL Ratings believes 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 Ratings' rating on Basel III-compliant Tier II capital instruments could typically be the same or one notch lower than the CCR of the bank.

Conclusion

Instruments issued under Basel III by banks are distinguished by their principal loss absorption features. They are chiefly of two types – Basel III AT 1 and Basel III Tier 2.

Basel III AT1 bonds are hybrids with features of both equity and debt. For a strong bank with high viability, Basel III AT1 instruments have more debt-like features and limited equity characteristics. In strong banks, there are likely to be limited risks to the servicing of coupons as well as exercise of call option to redeem these instruments. However, for weak banks or those less viable, these instruments start behaving more like equity and less like debt.

Recognising the unique credit risk characteristics of Basel III AT1 instruments, CRISIL Ratings has designed tailor-made criteria to assess their credit quality. CRISIL Ratings views the availability of coupon discretion, coupled with norms on distribution of reserves to make payments on such instruments, as the key risk factors in Basel III AT1 instruments.

CRISIL Ratings would typically rate a bank's Basel III AT1 instrument 1-3 notches lower than the bank's CCR. Higher notch-down from CCR will be considered if the bank's credit metrics are weak enough to merit that.

There is no significant impact of additional features in Basel III-compliant Tier II instruments vis-à-vis those under 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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It is India's foremost provider of ratings, data, research, analytics and solutions with a strong track record of growth, culture of innovation, and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers through businesses that operate from India, the US, the UK, Argentina, Poland, China, Hong Kong and Singapore.

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

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