CRISIL Ratings

Rating criteria for hybrid capital instruments issued by banks under Basel II guidelines

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Background

The Reserve Bank of India (RBI) allows Indian banks to raise hybrid Tier I and Tier II capital under Basel II regulations. These instruments (perpetual Tier I debt instruments and upper Tier II bonds) have helped banks augment their capital adequacy to face market and operational risks. This document details the treatment of hybrid instruments[1] (hybrids) under Basel II guidelines by CRISIL Ratings in its bank rating analyses, and the criteria adopted in rating such instruments (refer to Box 1 for key features of each form of hybrid capital).

The RBI, on May 2, 2012, had issued detailed guidelines on the implementation of Basel III capital regulations in India. CRISIL Ratings has published a separate document that outlines the criteria for rating Basel III-compliant non-equity Tier I and Tier II instruments (Refer to 'Rating criteria for Basel III - compliant non-equity capital Instruments')[2]

The CRISIL Ratings treatment of hybrid capital issued by banks under Basel II guidelines

The CRISIL Ratings treatment of hybrids in its bank rating analysis aligns with the regulatory treatment of the instruments. One of the main parameters CRISIL Ratings examines is the instrument's loss-absorption capacity. This is the extent to which the servicing of the instrument can be deferred, if the bank reports losses or if its capital adequacy slips below the minimum stipulated by the RBI. This is also relevant in case of liquidation, where the seniority of instruments will determine the order in which claims on the assets are met.

CRISIL Ratings considers innovative Tier I debt instruments and perpetual preference shares as part of core Tier I capital, as these are perpetual instruments with significant loss-absorption capacity. Though these instruments have call options beyond 10 years, banks may exercise the options only when their capital adequacy levels are comfortable or when new hybrid Tier I instruments are introduced.

Hybrids, such as upper Tier II, are included as secondary forms of capital while computing overall capital adequacy. Though these instruments possess some characteristics of equity (issuers can, for instance, decide not to pay interest or principal when their capital adequacy is less than the stipulated minimum), their loss-absorption capacity is not on par with that of a bank's equity capital. However, these instruments have historically allowed banks to expand their balance sheets and support growth. Hybrids under Basel II have aided credit profiles of banks by increasing diversity in funding, and helped improve asset-liability management on account of their long tenures.

Rating criteria for hybrids

The CRISIL Ratings rating criteria for perpetual Tier I debt instruments and upper Tier II bonds starts with an overall assessment of the bank's credit quality, which is determined by using the parameters under the CRAMEL framework. The rating criteria also takes into account the following characteristics of hybrid capital instruments issued under Basel II norms:

- Banks that are in breach of the minimum regulatory capital adequacy ratio (currently 9%) are not liable to make interest payments/principal repayments on these instruments.

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[1] For accessing the previously published document on 'Rating Criteria for hybrid capital in banks', go to https://www.crisilratings.com/content/dam/crisil/criteria_methodology/financials/archive/crisil-ratings-criteria-for-hybrid-capital-instruments-issued-by-banks-under-basel-II-guidelines-feb2021.pdf

[2] For accessing 'Rating criteria for BASEL III-compliant non-equity capital instruments', go to https://www.crisilratings.com/content/dam/crisil/criteria_methodology/financials/BASEL%20III%20compliant%20instruments.pdf

- Banks that are currently reporting losses, or will report losses as a consequence of interest payments on these instruments, will require prior permission from the regulator to pay interest. The regulator may permit the bank to pay interest if it is satisfied with the bank's capital adequacy position.
- If a payment is missed for either of the reasons mentioned above, CRISIL Ratings treats such missed interest payment/principal repayment as an event of default, even though this may be as per the terms of the instrument.
- For perpetual instruments, the rating indicates the probability of timely payment of interest/dividend, and does not comment on repayment of principal.

Events of default

Based on the features of hybrid capital, the following events of default are considered while rating hybrid instruments:

- The bank breaching the minimum capital requirement set by the regulator.
- The bank reporting losses, and the regulator denying permission to the bank to make interest/principal payment.
- Non-servicing of the instrument by the bank due to strained cash flow (this aspect is captured in the current framework of bank analysis).

CRISIL Ratings believes the probability of breach in minimum regulatory capital requirement subsumes all other events of default. Hence, the CRISIL Ratings rating methodology centrally focuses on this aspect. As perpetual Tier I debt instruments and upper Tier II bonds have similar triggers for default, the ratings on the two are likely to be identical.

Factors driving rating of hybrid capital

CRISIL Ratings considers the following aspects while rating hybrid instruments:

- The overall **credit quality of the bank**, which is reflected in the rating assigned to the bank's lower Tier II bonds. This rating acts as the cap for the rating on hybrid instruments, as events forcing default on lower Tier II bonds affect payment on perpetual Tier I and upper Tier II bonds, both of which are structurally subordinated to lower Tier II bonds.
- The current reported **capital adequacy** (both Tier I and overall capital adequacy) of the bank and expected capital adequacy over the medium term, vis-à-vis the minimum requirement set by the regulator. The expectations are driven by factors such as the bank's future growth in advances, possible erosion in capital due to asset quality challenges, or mark-to-market losses on investment portfolio.
- The bank's **ability to raise capital**, which is assessed based on factors such as the bank's current shareholding pattern, willingness of current shareholders to dilute holdings (particularly in the case of public sector banks), track record in raising capital, current market price if listed.
- For public sector banks, the current **stipulated minimum of 51% government shareholding** is also factored in.

Conclusion

Hybrid capital instruments (issued under Basel II) by banks are typically rated either at the same level or up to three notches lower than the rating on the bank's lower Tier II bonds. The rating would be identical to that on the lower Tier II bonds if the bank's expected capital adequacy is comfortably above the minimum requirement set by the regulator. In no instance will the rating on these hybrid instruments (issued under Basel II) be higher than the rating assigned to the bank's lower Tier II bonds.

Box 1

Key features of various forms of capital in banks issued under Basel II

The six types of capital that constitute a bank's capital structure, arranged in order of decreasing seniority, are:

Lower Tier II capital: These instruments have a minimum tenure of five years, and cannot exceed 50% of Tier I capital. There are no restrictions on servicing these instruments linked to the bank's capital adequacy or profit, but banks need to intimate the RBI before principal repayment. Lower Tier II capital, therefore, has no loss-absorption capacity. These instruments typically do not carry any put or call options.

Upper Tier II capital (under Basel II): These instruments have a minimum maturity of 15 years. In conjunction with lower Tier II capital, upper Tier II capital cannot exceed 100% of Tier I capital. Interest and principal payments on upper Tier II capital will not be made on time if the bank's capital adequacy falls below 9%, or if the RBI refuses permission to pay interest when the bank declares losses or will declare losses if the interest is paid. As a result, upper Tier II capital has good loss absorption capacity. Such a default can be cured subsequently by paying past overdues. The issuer can call back the instrument with prior approval from the RBI 10 years after the date of issue. At the same time, the issuer can also offer to step up the coupon by 100 basis points. No put options are provided on the instrument.

Innovative Tier I capital (under Basel II): These are perpetual instruments. Innovative Tier I instruments can form up to a maximum of 15% of total Tier I capital. Further, Tier I preference shares and innovative Tier I capital together cannot exceed 40% of Tier 1 capital. Interest payment on innovative Tier I capital cannot be made on time if the bank's capital adequacy falls below 9%, or if the RBI refuses permission to pay interest when the bank declares losses or will declare losses if the interest is paid. Such a default cannot be cured as the instrument is non-cumulative. Innovative Tier I capital, therefore, has good loss-absorption capacity. The issuer can call back the instrument with prior approval from the RBI 10 years after the date of issue. At the same time, the issuer can also offer to step up the coupon by 100 basis points. No put options are provided on the instrument.

Tier I preference capital (under Basel II): These are perpetual instruments. Tier I preference shares and innovative Tier I capital together cannot exceed 40% of Tier 1 capital. Dividend payments on Tier I preference capital cannot be made on time if the bank's capital adequacy falls below 9%, or if RBI refuses permission to pay dividend when the bank declares losses. Such a default cannot be cured as the instrument is non-cumulative. Tier I preference shares have better loss-absorption capacity compared with innovative Tier I capital, as payments on these instruments are in the nature of preference dividend (to be paid only if allocable profit exist), and not interest.

The issuer can call back the instrument with prior approval from the RBI 10 years after the date of issue. No put or coupon step-up options are built into these instruments. Banks cannot issue preference shares as per the current provisions of the Banking Regulation Act. The RBI is yet to issue guidelines to banks on these instruments.

Equity: Part of Tier I capital, equity is perpetual, with no put or call options. There are no contractual payments to be made, and equity has the maximum loss-absorption capacity of all classes of capital

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