



# **Criteria for Rating Hybrid Instruments Issued by NBFCs, HFCs & Banks**

## Introduction

The regulatory framework governing the capital adequacy requirements for banks and non-banking finance companies (NBFCs), including Housing Finance Companies (HFCs), has resulted in the introduction of hybrid instruments aimed at strengthening the regulatory capital base for these financial institutions. These instruments have attributes of both- equity and debt instruments and are differentiated based on their loss absorption characteristics.

These instruments typically carry a higher risk, mainly because the issuers could face restrictions on servicing the coupon on these instruments in case their capital adequacy is below the levels stipulated by the Reserve Bank of India, or in case of losses incurred by the issuer.

Type of Instrument	Characteristics*				
	Maturity	Capital Treatment	Seniority	Discretion Regarding Coupon Payment	Loss Absorption Capacity
Lower Tier II Debt Instruments (Sub-Debt)	Minimum 5 years	A portion of the Lower Tier II Debt forms a part of the Regulatory Capital of the issuer	These bonds are subordinated to other creditors/ senior debt	None	None
*Upper Tier II Instruments	Minimum 15 years	Upper Tier II Capital and Lower Tier II Capital cannot be in excess of the total Tier I Capital	Subordinated to all creditors - excluding Tier I debt	Coupons may be deferred and are cumulative	Principal may be written down in case of shortfall in regulatory capital
Tier I Bonds (Perpetual Debt)	Perpetual	Part of the Tier I Capital up to a maximum	Subordinated to all other creditors	Coupons are deferred if the regulatory capital falls below the statutory	In case of accumulation of losses/ shortfall in regulatory

		of 15% of the total Tier I Capital. Excess quantum shall be included as a part of the Tier II Capital		requirement, or in case payment of the coupon results in the regulatory capital falling below the statutory requirement	capital requirements, the principal amount may be written down
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\*Under Basel-II

### Rating Framework

Acuite's evaluation of hybrid instruments is a two-step process:

1. The long-term conventional bond rating (Senior Bond rating) of the issuer is evaluated in line with the relevant rating criteria. The various operational and financial parameters like capital adequacy, asset quality, earnings quality etc., are examined while arriving at the rating for the Senior Bonds. Subsequently, the Resource Mobilisation Ability of the issuer is examined by considering various aspects like current funding profile, likelihood of parent/group support, shareholding pattern, and demonstrated ability to augment its capital structure from diverse sources. The criteria for rating NBFCs are available on: <https://www.acuite.in/view-rating-criteria-44.htm>

The rating so arrived at, based on step 1, will be the upper cap for the rated hybrid instrument. Acuite believes that any instance of default on the senior debt or the Lower Tier-II debt shall inevitably lead to default on the issuer's hybrid instruments. Acuite may equate the rating of the subordinated debt instrument with that of the conventional debt in case of an absence of significant loss absorption characteristics in such instruments.

2. The final rating for the Hybrid Instrument is then either equated or notched down based on factors like the issuer's:
  - a. Current Capital Adequacy Ratio (CAR) and the cushion available with regard to the regulatory requirement.
  - b. Expected movement in CAR over the medium-term, factoring in the expected capital mobilisation vs the expected growth rate in Risk Weighted Assets.
  - c. Probability of Servicing the coupon/ interest in the event of loss.

Based on the above factors, Acuité may maintain a differential up to three notches. It is pertinent to note that the differential is not linear and the standalone rating of the bank (in case there is a notch up for any government or parent support) is a key factor in deciding the differential. In case of banks at the higher end of the rating band (i.e., stronger banks), the difference between senior bonds and AT1 instruments could be lower vis-à-vis a relatively weaker bank.

In this context, the differences between the Basel II & Basel III dispensation needs to be appreciated. It has to be understood that under Basel III, the loss absorption characteristics of Additional Tier 1 (AT1) instruments are higher vis-à-vis under Basel II dispensation. An AT1 instrument under Basel III issued by a bank shall have loss absorption features (conversion/ write-down/ write-off) on breach of Common Equity Tier 1 (CET 1) triggers or at PONV (Point of Non-Viability). The coupons in respect of these instruments may be paid out of distributable items & free reserves (in the event of inadequate profits during the current year) subject to compliance with CET 1, Tier I & Total Capital ratios, and interest shall not be cumulative. The claims of the holders of these AT1 instruments are senior only to the claims of equity shareholders and Perpetual Non-Cumulative Preference Shareholders. These instruments do not have a put option; however they may have a call option after 5 years from issuance to be exercised, subject to RBI approval.

Basel III-compliant Tier II instruments have a feature to be invoked at the PONV, thereby providing a buffer to depositors and senior creditors. While they may not have an interest deferral clause, these instruments are designed to absorb losses on PONV triggers through write-downs/ conversion to equity as per the regulatory directives. The rating of Tier II instruments under Basel III will be generally aligned to the Lower Tier II instruments under Basel II for banks at the higher end of the rating spectrum. Based on past experience, with respect to PSU Banks, the Government has been proactive in ensuring capital infusion to ensure that the capital buffers remain above the PONV levels. It has to be understood that the likelihood of reaching PONV is much lower than the possibility of breach of overall capital adequacy. Hence, the probability of default on Upper Tier II instruments (Under Basel II) will be higher than the Tier II instruments (under Basel III).

Acuité also notes that in the recent past, the financial sector regulators (RBI and NHB) have allowed issuers to service their interest/ coupon commitments on hybrid instruments despite reporting losses- subject to complying with minimum regulatory capital requirements. However, Acuité takes note that in certain unforeseen circumstances, such approvals may be withheld by RBI/ NHB and thus the same constitutes an important risk factor in the evaluation of hybrid instruments.

### **Treatment of Preference Shares**

Preference Shares can also be issued by banks for meeting their capital adequacy requirements. While Preference Shares carry fixed dividends (as opposed to equity dividends which may vary from year to year), however it has to be noted that dividend payments on preference shares are discretionary i.e., at the option of the issuer. For all practical purposes, the issuers will prefer to maintain their dividend payouts on the preference shares even during periods of extreme profitability stress as any skipping of dividends will be construed as a signal of credit weakness among

investors and external stakeholders. The payouts during years of weak profitability performance could require the concurrence of the regulator especially if the capital adequacy levels are close to regulatory thresholds and the payouts could exacerbate the pressure of the capital adequacy front. Typically, PNCPS (Perpetual Non-Cumulative Preference shares) issued by banks are treated as a part of Tier I capital within the overall AT1 limit of 1.5% of RWAs subject to these instruments satisfying certain regulatory requirements. Also, RCPS (Redeemable Cumulative Preference Shares), PCPS (Perpetual Cumulative Preference Shares) & RNCPS (Redeemable Non-Cumulative Preference Shares) are to be treated as Tier II capital of banks.

Acuité's approach will be similar to the approach followed in respect of other hybrid instruments depending on the seniority status of these instruments.

### Default Risk Drivers

The default risk arising out of non-payment of coupon/ interest on hybrid instruments is linked to the likelihood of the Capital Adequacy Ratio (CAR) of the issuer falling below the regulatory requirement.

Acuité evaluates two risk factors to ascertain the probability of the occurrence of any of the above events of default:

- i. **Capital adequacy and historic volatility in CAR:** The CAR requirement varies across categories of issuer. NBFCs are required to maintain a CAR of 15% while HFCs are expected to gradually move towards 15% in a phased manner. Acuité examines the individual components of CAR (such as Common Equity Ratio, etc.) and how it compares to the regulatory requirements.

Acuité further assesses the available headroom between the current CAR of the issuer vis the regulatory requirement. The historical volatility in CAR enables Acuité to estimate the propensity of the issuer's CAR deteriorating below the regulatory requirement.

Acuité evaluates the expected movement in the internal accretion to the issuer's net worth and movement in the risk weights in the issuer's portfolio. An issuer's CAR may experience significant deterioration in case the issuer decides to take on relatively riskier lending practices or experiences a sudden spike in delinquency levels. Acuité relies on expected movements in indicators such as Net Interest Margin and Return on Average Assets to assess the quality of internal accretions to the net worth of the issuer over the medium term.

- ii. **Likelihood of servicing the coupon on Hybrid Instruments in the event of loss:** The issuer may be required to seek the approval of the regulator in order to service the coupon due on such instruments in the event of loss- even if adequately capitalised in line with regulatory requirements.

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