

Methodology

*Rating Bank Preferred Shares
and Equivalent Hybrids*

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Insight beyond the rating.

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Introduction

This methodology addresses the level of notching for preferred shares and equivalent hybrid instruments (collectively, preferred shares) relative to issuer ratings for banks and other financial institutions that are highly leveraged relative to the leverage seen in most corporate issuers. For simplicity, we will refer to banks, but the methodology applies to certain other financial institutions that fit this profile. The combination of high leverage and the importance of adequate capital for a bank's viability increase the risk of nonpayment of preferred share dividends and/or adverse exchange offers of common equity for preferred shares relative to the risk for similarly-rated corporate issuers. These actions provide ways for a bank to quickly build up loss-absorbing common equity. The inclusion of "equivalent hybrid" denotes that this methodology also applies to hybrid securities that either convert into preferred shares rather than into junior subordinated debt or have other characteristics whereby DBRS would treat the instrument in the same fashion as it would preferred shares.

In summary, there are two major changes occurring in this methodology relative to the prior DBRS methodology for rating bank preferred shares.

(1) For those banks that benefit from support, the starting point for notching preferred share ratings will now be based on the intrinsic assessment (IA) rating rather than on the final senior debt rating. The DBRS support assessment methodology means that the IA is usually lower than the final senior debt rating for such banks. This change reflects the view that external support should provide no rating uplift for equity-type securities.

(2) The degree of notching from the IA rating to the preferred share rating has been widened to reflect our perception that the risk in these capital instruments has increased, although there is some flexibility to make adjustments to reflect the position of individual banks, as explained below. This extends the long held core principle of rating more junior securities at lower levels. In addition to the implied higher risk of default, this also in part recognizes that there is a higher expected loss for junior securities that default than for more senior ranking securities.

Risk of Nonpayment

The risk of default for preferred share instruments is significantly higher than for senior obligations as nonpayment of interest is generally commensurate with a bank's bankruptcy and/or insolvency. For certain types of financial institutions, the risk of nonpayment is further increased relative to senior obligations because these banks are highly leveraged, typically with significant risk exposures that can cause large losses relative to the size of their capital bases.

While infrequent, large losses, writedowns or sudden escalations in perceived risk are not unlikely events for banks. When they do occur, they are often abrupt and can result in a potentially rapid reduction in capitalization. Customers' or counterparties' concerns that a bank may no longer be a reliable counterparty can result in a loss of business or deposit outflows that, if rapid, sustained and extensive, may significantly damage the bank's franchise and future earnings. To prevent this loss of confidence, banks will look for ways to bolster capital quickly.

One of the ways for banks to do this is to cut common dividends. Another is to cut or eliminate preferred share dividends if these steps would contribute meaningfully to preserving capital. Another way to build capital is to make an offer to exchange preferred shares for common shares. Such "offers" may in fact be



forced exchanges or they may not be a true offer in the sense that there may be no other viable option for preferred shareholders but to accept the conversion. DBRS views such coercive exchanges as a default.

Increasing the risk in these instruments is DBRS's perception that regulators and governments are now more committed to making capital instruments play the role that they were created to play – that is, to provide capital. To get government support, banks may face greater pressure to take such capital-enhancing actions either before or in conjunction with getting government support.

Changing Regulatory Environment

An additional factor that is likely to increase the risk of such adverse actions for preferred shares appears to be the reversal of more than a decade of increased reliance on preferred shares and other hybrid instruments to bolster regulatory capital. Given the loss-absorption role of common equity, the financial markets and increasingly the regulators are looking to banks to bolster their common equity capital as opposed to other forms of capital. This drive has become more acute after the rapid erosion of common equity that some banks experienced due to significant writedowns.

In DBRS's view, in a stressed scenario, the regulators are now more likely to pressure banks to improve their capital structure by increasing common equity. For banks with preferred shares, this pressure is now more likely to result in adverse actions for preferred shareholders. As such, the risk in these instruments has increased.

Aligning Notching with Increased Relative Risk

Underlying the change in the notching between senior issuer ratings and preferred share ratings is the recognition that two notches were not enough to recognize the increased risk of adverse actions on preferred shares by issuers in this new regulatory and financial markets environment. In particular, two notches below AA was not always enough as the nonpayment of dividends or exchange offers for preferred shares are much more likely to occur than the nonpayment of interest on debt obligations. The fact that preferred shares are typically long-dated or perpetual in nature further adds to the importance of establishing this methodology as the ability to sell these instruments, particularly at acceptable pricing, would likely be under pressure should the issuer in question come under meaningful stress.

The weaker the institution, the greater the probability that a nonpayment of preferred shares will occur after a significant loss or deterioration in financial health. That suggests a widening gap as a bank's senior issuer rating is lowered. For example, in the base notching scale shown below, for banks with an intrinsic assessment rating of A (low) or below, the risk for preferred shares is perceived to be non-investment grade.

For banks whose final rating benefits from the support assessment, the notching is made from the intrinsic assessment as banks are likely to be required to use preferred shares as a source of capital either before or in conjunction with support from the government. Government actions to bolster the strength of the bank are likely to come at the expense of holders of equity instruments.



Base Notching Policy from Intrinsic Assessment Ratings

| Senior | Preferred Shares | |
|----------------------|------------------|---|
| Three Notches | | |
| AA (high) | A (high) | DBRS alerts investors to higher risk of nonpayment, even for highly rated banks |
| AA (low) | A (low) | Risk is still very low as identified by "A" category |
| Four Notches | | |
| A (high) | BBB | For A (high) banks, less resiliency and increased risk of adverse events affects the preferred share rating |
| A (low) | BB (high) | Risk of falling into BBB category with higher capital stress means non-investment-grade rating for preferred shares |
| Five Notches | | |
| BBB (high) | BB (low) | More immediate pressure to raise capital, if needed, but may be more difficult for weaker BBB bank |
| BBB (low) | B | Bank is only one notch away from non-investment grade, making capital more difficult to raise if needed |

Adjustments to Base Notching

While the base notching as discussed above is the starting point for every rating decision on bank preferred shares, DBRS policy permits exceptions to the base notching for all rating levels (either above or below) to reflect the unique considerations of individual banks. Key considerations include the following:

- Mix and strength of the capital structure (including the proportion of preferred shares in the capital structure).
- Actions taken on common dividends (recognizing that these actions are the first buffer).
- Any other unique stresses or lack of stress within the domestic financial system, such as the expected actions possible from external parties (regulators, governments).
- The robustness and expected consistency of the bank's earnings.
- Accessibility to capital markets.
- When the aforementioned factors present a strong case, other possible considerations may also include where the IA rating is within the broader rating category and whether the issuing entity is the bank or the holding company

Treatment of SA1 Situations

Within the DBRS methodology for support assessment of banks (*Enhanced Methodology for Bank Ratings – Intrinsic and Support and Assessments*, February 2009), DBRS defines the SA1 category as relating to very strong and predictable support in the form of a guarantee or ownership and control, where the rating would be equal or slightly below the rating of the parent. When this situation exists, it adds a level of complexity to the question of how to notch the preferred share rating of the benefiting entity (i.e., the subsidiary). DBRS has decided that in such cases, the preferred share rating for the subsidiary will be notched relative to the preferred share of the parent in the same way that all debt ratings are notched between the two entities.

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