

DBRS Criteria: Rating Bank Subordinated Debt and Hybrid Capital Instruments with Contingent Risks

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Introduction

This criteria explains DBRS's approach to rating a subset of hybrids and other debt capital instruments whose features include principal write-downs or conversions to lower positioned instruments, if certain trigger events occur. Within this relatively limited subset of debt capital instruments with these contingent risks, DBRS draws an important distinction in its ratings between those instruments where these adverse events are reversible, if a bank survives, and those instruments where these adverse events, once triggered, are irreversible, even if a bank survives. Accordingly, instruments with reversible contingent events are generally rated like other debt instruments that otherwise have similar characteristics. However, instruments with the elevated risk from irreversible contingent events are generally rated lower with notching driven by DBRS's preferred rating scale for banks. This clarification primarily addresses instruments already issued by European banks, but also lays out the framework for rating other instruments in the future.

DBRS's approach to rating these instruments focuses on the extent to which their distinctive features elevate the risk for debt investors above the normal risk of loss from a bank becoming insolvent, bankrupt, or seized by regulators. Risk for debt holders involves both the likelihood of insolvency or other adverse events and the expected loss incurred if triggers are tripped and these adverse events occur. To explain our approach, we discuss first the nature and potential for loss that investors are exposed to and then consider the likelihood of the triggers being tripped.

This criteria should be considered in combination with DBRS's other methodologies that address the extensive range of bank hybrid and debt capital instruments, as well as DBRS's approach to rating bank preferred shares.

1. Background: The Contribution of Hybrids and Debt Capital Instruments to Bank Capital

The features addressed here are a relatively small subset of the broad array of features that have been developed with the intent of enabling these instruments to perform some of the roles of capital for banks. DBRS views equity instruments as combining permanence, the lowest position in the capital structure, and the ability to halt contractual payments without default. Channeled by regulators' demands, fixed income investor appetite, tax policies and managements' approach to optimizing capital costs, the evolution of bank capital instruments have incorporated various elements of equity capital in their diverse features.

Many bank capital instruments are perpetual or have long maturities. Some are very junior in the capital structure. Step-ups and call features also are important in providing some permanence to these capital instruments if a bank gets into difficulty, but limit the anticipated maturity for a bank that remains sound. Some instruments have discretionary payments, which can be cumulative for some instruments and non-cumulative for others. Despite their numerous features, DBRS sees most of these hybrids as having limited ability to provide capital to absorb losses, while a bank is still solvent and operating. As a result, DBRS rates most of these instruments as debt, rather than as equity like preferreds. Certain of the instruments that we are addressing here, however, come closer to providing actual equity capital when a bank is in difficulty and triggers are tripped.

This view that most hybrids are closer to debt than equity was evident in the global financial crisis. Despite all their 'bells and whistles', most of these bank capital instruments could not be converted into



equity to help struggling banks absorb losses and bolster their capital while they were still operating. The main benefit for bank equity capital came when banks made exchange offers for hybrids, either at less than par or for equity instruments. The limited contribution to equity capital is consistent with DBRS's perspective on the function of these instruments for banks. In analyzing the contribution of bank capital instruments to a bank's capitalization, DBRS does not generally give any significant equity credit for hybrid instruments, although we recognize their full value in meeting regulatory requirements.

2. Risk in Contingent Write-Down Features

To enable certain hybrids to provide capital when a bank is under stress, some instruments have features that permit their principal to be written down under certain circumstances before a bank is insolvent. This principal write-down boosts book equity, while the bank is still a going concern. By creating equity capital, this event helps a bank maintain minimum levels of capital and meet regulatory requirements, without which it might be insolvent or be forced into some form of resolution.

For many instruments, this feature creates less additional risk for the instrument holder than might be supposed, because these write-down features are reversible, if the bank survives. Conditions are laid out under which the obligation is written back up as a bank recovers. These write-backs can be driven by a bank's ability to generate earnings or raise new capital. There are usually constraints on a bank until the principal is written back up, such as limits on the payment of dividends. Thus, in DBRS's view, the holder of these hybrids is generally no worse off than if the write-down feature was not present. The dominant risk to the holder remains a bank's insolvency, when hybrid debt holders can expect little or no recovery.

Given our perspective, we do not generally adjust our ratings for capital instruments with these reversible write-down features. If the bank does not survive, holders of these instruments are in largely the same position as they would have been without the write-downs. For some instruments, the holders' claim reverts to 100% of the original hybrid amount if the bank still becomes insolvent, regardless of the write-down. For other instruments, the hybrid holders' claim in insolvency is zero. This outcome is nevertheless not significantly different, given our assumption that sub-debt and hybrid holders recover zero or close to zero when a bank becomes insolvent.

For hybrids where any principal write-down is irreversible, however, the holder is exposed to the added risk of principal write-downs that could occur without the bank becoming insolvent. This risk of loss is more comparable to the risk of loss for preferred shareholders than for debt holders. In assessing this risk, our approach considers the priority of the instrument and what determines the extent of any write-downs. The analysis also considers the order in which write-downs would occur. A more senior instrument may be better protected against write-downs by more junior instruments.

3. Risk in Contingent Conversion Features

Another feature that exposes hybrid holders to contingent risk is one that permits these hybrids to be converted into instruments that have less attractive features, when certain triggers are tripped. In some cases, the hybrid is converted into an instrument that facilitates write-downs. In other cases, the conversion is into equity instruments, such as preferred shares or common equity.

If the conversion is reversible, however, the holder generally has limited additional risk from these conversion features relative to an instrument without such a conversion feature. Nevertheless, the notching can



reflect the conditions under which re-conversion can occur. Some instruments specify that the position of hybrid holders in insolvency is the same as preferred shareholders. Based on our view that recovery for hybrid holders is close to zero, this lower position does not significantly increase the risk that holders face. Notching is therefore generally not adjusted for such ranking.

When these contingent conversions are irreversible, DBRS sees such instruments as posing significant additional risk for holders beyond the risk of insolvency. If the conversion is irreversible, then the rating for the instrument reflects both the features of the new instrument and its position in the capital structure, as well as the ease of tripping the trigger that results in conversion.

With irreversible conversions, the closer the new instrument is to common equity and the further it is from the most senior of subordinated debt, the greater the risk for investors and the more likely that additional notching would be applied to incorporate the additional risk from their lower position and the potential for greater loss upon conversion. The additional notching may also reflect uncertainty about the regulatory or legal position of the new instruments. This uncertainty may also be applicable in those cases where the new instruments can be further converted into even lower ranking securities.

4. Ease of Tripping Triggers

In assessing the additional risk of these contingent features, an important factor is the ease of tripping the triggers that cause the adverse event to occur. The easier the triggers are to trip, the greater the additional risk for the hybrid holder. DBRS organizes the ease of tripping triggers into four broad categories:

- Level 4 “Very Hard”, e.g., Bank is insolvent or has been seized
- Level 3 “Hard”, e.g., Bank has exhausted most of its capital, but is not technically insolvent
- Level 2 “Easier”, e.g., Bank no longer meeting minimum regulatory requirements
- Level 1 “Easiest”, e.g., Capital ratio falls below a level set above minimum requirements

For those instruments where the trigger event requires the bank to be insolvent or seized by the authorities, DBRS views the risk as similar to debt instruments.

5. Notching For Instruments with Exposure to Reversible Adverse Events

For those instruments where the write-downs or conversions to lower positioned instruments can be reversed, if the bank survives, the risk to investors remains largely the same as it would be in the absence of the feature. That is, investors face losses only if the bank is declared insolvent.

Accordingly, for subordinated debt and hybrid instruments whose features do not materially raise the risk to holders above the risk of insolvency, the ratings are notched from the senior unsecured rating (the final rating) to reflect their predominantly debt-like characteristics. DBRS views the final rating, which can benefit from systemic support, as the best representation of the likelihood of default or insolvency of the bank, bank holding company or banking group. The notching for these debt-like hybrids considers the additional risk in terms of expected loss relative to the position of senior debt.

As explained in our press release on 21st December 2009, DBRS does not view the ability to defer payments as a credit risk, but rather, a risk that holders of these instruments have agreed to under the contractual terms of the instrument. Therefore, DBRS does not consider “deferral” as being equivalent to



“default”. When instruments with discretionary payments defer or skip DBRS adds an additional notch as long as such payments are not being made to differentiate these instruments from ones that are still paying.

6. Notching For Instruments with Exposure to Irreversible Adverse Events

For instruments whose risk to holders is sufficiently elevated by contingent risk, the ratings are based on DBRS’s approach to rating preferred shares for banks. The notching relative to the preferred rating scale reflects the additional risk from the combination of the likelihood of the adverse event and the expected loss if the event occurs.

The first step is evaluating the elevated risk posed by the specific features of each instrument. For some instruments, the combinations are relatively straightforward. An instrument with triggers that are hard to trip and resulting positions that are above preferreds is viewed as having elevated risk. For instruments with triggers that are easier to trip and resulting positions that are comparable to preferreds, the risk is viewed as being very elevated. Under DBRS’s approach certain instruments with contingent features can pose exceptional risk, if their triggers are the easiest to trip and the resulting position for holders is closer to common equity. One factor in rating these instruments below preferred shares could be that tripping the triggers could occur without preference shares being impacted or leave them in a preferential position relative to the converted instruments. Outside these straightforward combinations, there are a number of combinations that involve judgment in making the assessment of risk (See Exhibit 1). or those instruments where the write-downs or conversions to lower positioned instruments can be reversed, if the bank survives, the risk to investors remains largely the same as it would be in the absence of the feature. That is, investors face losses only if the bank is declared insolvent.

Exhibit 1: Additional Risk Based on Ease of Tripping Triggers and Resulting Position				
		Ease of Tripping Triggers		
		Hard	Easier	Easiest
Priority of Write-Downs or Resulting Instrument	Above Prefs	<i>Elevated Risk</i>		
	Preferreds		<i>Very Elevated Risk</i>	
	Below Preferreds			<i>Exceptional Risk</i>

DBRS’s Approach to Rating Preferreds

DBRS’s approach to rating preferreds for banks has two features. First, the notching for preferreds widens as a bank’s fundamentals deteriorate to reflect the increasing risk of adverse events occurring. Second, the notching starts with the bank’s intrinsic assessment (IA), which is driven by a bank’s fundamentals, but does not incorporate any implicit support. The benefit to the final ratings from implicit support for systemically important banks rated SA2 is typically one notch above the IA. In some cases, where the extent of support is more substantial, the benefit can mean a wider gap between the IA and the final rating, for example, when floor ratings apply to critically important banks or other special circumstances. Like preferred shares, DBRS views these higher risk hybrids as unlikely to benefit from systemic support.

Under our policy for preferreds, the standard notching from the intrinsic assessment adds 3 notches for AA-category banks, 4 notches for A-category banks and 5 notches for BBB-category banks (See Exhibit 2). While the standard notching approach is the starting point, DBRS policy permits exceptions to reflect



any unique circumstances of each bank, as well as the treatment by the regulators, other authorities or government entities, which may vary by country. For more detail, see our methodology “Rating Bank Preferred Shares and Equivalent Hybrids”, June 2009

Notching Policy for Contingent Risk Instruments

When the additional risk from the contingent features is assessed to be similar to preferreds and very elevated relative to debt instruments, there would be no differential from the standard notching for preferreds. Where the contingent features pose risk that is somewhat elevated risk relative to debt instruments, but constitute less risk than preferreds, the standard notching is one better than the preferred scale. For those instruments that pose exceptional risk relative to debt instruments, the standard notching is one worse than for preferreds, but could be more if warranted by the contingent risk. (See Exhibit 2)

Exhibit 2: Standard Notching from Preferred Rating Scale to Reflect Additional Risk				
		Additional Contingent Risk		
		Elevated	Very Elevated	Exceptional
		<i>One Notch Better</i>	<i>No Differential</i>	<i>One Notch Worse</i>
Intrinsic Assessment	Preferred Rating	Hybrid or Debt Capital Instrument Rating		
AA	A	AH	A	AL
A	BBBL	BBB	BBBL	BBH
BBB	BH	BBL	BH	B

While our approach is straightforward, it involves significant judgment in determining the nature of the various features. Some instruments may have features that do not permit the assessment of the risks. Triggers may lack definition. Trigger events may be poorly specified and difficult to predict. Contingent events may not be sufficiently defined. Difficulty in assessing the risk in such instruments could also result in DBRS being unable to rate these higher risk instruments.

Related methodologies are:

- [Global Methodology for Rating Banks and Banking Organisations](#)
- [Rating Bank Subordinated Debt and Hybrid Instruments with Discretionary Payments](#)
- [Rating Bank Preferred Shares and Equivalent Hybrids, June 2009](#)
- [Enhanced Methodology for Bank Ratings – Intrinsic and Support Assessments](#)

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