

DBRS Criteria: Rating Bank Subordinated Debt and Hybrid Instruments with Discretionary Payments

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Insight beyond the rating.

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Introduction

This criteria deals principally with DBRS's approach to rating bank debt capital instruments that have discretionary payments, as well as the impact on ratings of actual deferrals. These instruments include subordinated debt, junior subordinated debt and hybrid debt that does not convert to preferred shares of banks, bank holding companies and banking groups. As we explained when it was first released in December 2009, our approach takes into account the evolving regulatory environment that has affected the treatment of these instruments.

This criteria should be considered in the context of other DBRS methodologies that address various aspects of bank hybrid and debt capital instruments, as well as the approach to rating bank preferred shares.

1. Notching Debt Instruments from Final Rating

This criteria concerns debt and debt-like instruments. Accordingly, the notching for subordination and other characteristics starts from the senior unsecured rating (the final rating), which can benefit from systemic support. DBRS views this rating as the best representation of the likelihood of default or insolvency of the bank, bank holding company or banking group. The notching represents the additional risk in terms of expected loss or other adverse outcomes relative to the position of senior debt.

While these debt instruments are often viewed by regulators as having capital characteristics, their nature means that their ability to provide a capital cushion to depositors and senior debt holders can generally only play a major role when there is an insolvency or a bank seizure. In effect, the capital characteristics are generally only achieved when the bank or issuing entity has become a "gone" concern. If the debt instruments have other features that significantly increase the extent of any additional risk in terms of expected loss, for example with principal reduction terms where triggers are readily breached, this additional risk is reflected in the notching.

For preferred shares and other hybrids that convert to preferred shares or equity-like instruments, DBRS notches the ratings for these instruments from the intrinsic assessment. DBRS views these instruments as considerably more exposed to risk of adverse action by management and/or regulators prior to a bank becoming insolvent or subject to regulatory seizure. This risk is more related to the intrinsic strength of the bank and its need for common equity. Moreover, equity-like instruments are unlikely to benefit from systemic support.

2. One-Notch Differential for Mandatory Pay and Cumulative Discretionary Pay Subordinated Debt

For mandatory pay subordinated debt and discretionary pay subordinated debt instruments, where deferred payments are cumulative, DBRS maintains its current policy of a one-notch differential between these instruments and the senior debt rating.

The same one notch policy applies to cumulative discretionary pay subordinated debt, which is typically junior or deeply subordinated debt. DBRS's analysis of default and recovery rates supports this opinion.



The differences between subordinated debt and cumulative junior subordinated debt do not warrant a rating notch difference, particularly when consideration is given to the fact that subordinated debt is already rated one notch below senior debt.

Both types of instruments are viewed as elements of capital from a regulatory perspective, subject to certain limitations. DBRS does not view the ability to defer payments as a credit risk, but rather, a risk that holders of the deferrable instruments have agreed to as per the contractual terms of the instrument and DBRS does not consider “deferral” as being equal to “default”.

3. Two-Notch Differential for Non-Cumulative Discretionary Pay Subordinated Debt

For instruments with noncumulative discretionary pay characteristics, the additional risk of payments being skipped is viewed as sufficient to differentiate these instruments by an additional notch from those with mandatory pay or cumulative discretionary pay characteristics. These instruments will now be widened to two notches below senior debt.

Again, DBRS views the ability to defer payments as a risk that holders of the deferrable instruments have agreed to under the instrument’s contractual terms and skipping of payments is not equivalent to default, provided that it is performing according to its contractual terms. Other characteristics that add to the risk of these instruments’ ratings are also taken into account. These characteristics include triggers, principal write-downs, regulators’ authority and mandatory payment features. The approach to instruments with these features is explained in a separate methodology.

4. Notching for Deferral or Skipping of Payments

DBRS adds an additional notch when instruments with discretionary payments defer or skip. This notch will be applied as long as discretionary payments are not being made. This additional notch serves to differentiate between instruments that are still making payments from those that are not paying, but otherwise meeting the instrument’s terms and covenants.

As noted already, DBRS does not view the exercising of the right to defer or skip payments as equivalent to default. Typically, a bank that defers or skips discretionary payments is usually in significant difficulty, so that its senior debt rating is already under pressure and its rating has likely been lowered. That results in lower ratings for subordinated debt. Recent examples, however, have illustrated occasions when a bank may defer or skip due to regulatory events, but retain significant strength and remain investment grade. In these circumstances, the senior debt rating remains the principal driver of the likelihood that payments will be resumed and insolvency avoided.

Related methodologies are:

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

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