Bank Hybrid Capital Rating Methodology

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Overview and Scope of the Criteria

The criteria apply to hybrid capital instruments issued by commercial banks incorporated in Thailand. These include Basel III-compliant Additional Tier-1 (AT1) and Tier-2 capital instruments that are fully recognized as part of a bank's Tier-1 and Tier-2 capital, respectively, in accordance with the regulations of the Bank of Thailand (BOT) on components of capital for banks incorporated in Thailand. The criteria supersede "Rating Methodology: Hybrid Tier 2 Capital Securities," published on 30 April 2014.

Definitions

Bank hybrid capital instruments in general have characteristics of debt and equity. The amount raised from issuance of hybrid capital instruments is eligible to be counted as part of Tier-1 or Tier-2 capital but is typically reported as debt on bank balance sheets. In the event the issuing bank's financial condition deteriorates to the point of non-viability, the instruments are subject to principal write-down or write-off, or may be converted into common equity to absorb losses. For details on the features of AT1 and Tier-2 instruments based on the BOT's regulations, please refer to Appendix A and Appendix B.

Methodology

We rate a hybrid capital instrument by determining the number of notches to be deducted from the Issuer Credit Rating (ICR) assigned to the issuing bank. The sum of the number of notches being deducted is primarily tied to the existence of the following three main characteristics typically seen in hybrid capital instruments:

(1) Contractual subordination

According to the priority of claim typically set among creditors of a commercial bank, Tier-2 instruments are generally junior to preferred creditors, depositors, and general creditors, while AT1 instruments are junior to preferred creditors, depositors, general creditors, subordinated debt, and Tier-2 instruments. To reflect the inferiority of hybrid capital instruments with respect to priority of claim, the rating assigned to an AT1 or Tier-2 instrument incorporates at least one notch down from the ICR assigned to the issuing bank. In case where the ICR assigned to the issuing bank is non-investment grade (below BBB-), the deduction of notches is increased to two notches to reflect the increased probability of a distressed scenario.

(2) Risk of partial or untimely payment

One distinct feature that differentiates an AT1 from a Tier-2 instrument is that for AT1 the issuing bank has a contractual right to cancel coupon payments at any time, and there exists the risk of other going-concern conditions leading to non-payment of interest that could be triggered by the regulator's intervention in a stress scenario. The rating assigned to an AT1 instrument therefore incorporates an additional two-notch deduction to reflect the risk of partial or untimely payment. Since Tier-2 instruments issued by commercial banks in Thailand typically do not include a coupon-deferral feature, the rating assigned to a Tier-2 instrument typically is not subject to a notch-down with respect to risk of untimely payment. However, should the right to defer coupon payment exist as part of the conditions of the instrument, then the Tier-2 instrument will be subject to a one-notch deduction.

(3) Loss absorption features

We deduct one more notch for both AT1 and Tier-2 instruments. This is to reflect the risk of loss absorption due to mandatory contingent capital clauses that leads to equity conversion or capital write-down (or both). AT1 instruments commonly have features to absorb losses in two scenarios: (1) on a going-concern basis comparable to common equity; (2) in a scenario of non-viability where the issuing bank can no longer continue business operations. Tier-2 instruments, on the other hand, are only subject to loss absorption in the situation of non-viability.

On a going-concern basis, the BOT regulations currently stipulate that AT1 instruments are convertible into common equity, or the principal is subject to permanent partial or full write-down, when the bank's Common Equity Tier 1 (CET1) ratio (CET1 capital to total risk-weighted assets) falls below the trigger level which is set at above 5.125% (the issuing banks are allowed to set a higher trigger point). The amount of debt-to-equity conversion or principal write-down must be at least equal to the amount needed to maintain the CET1 ratio above the trigger point.

If a bank's financial condition deteriorates to the point of non-viability and the authorities decide to provide financial assistance to the issuing bank, both the AT1 and Tier-2 instruments will be mandatorily converted into common shares or written off. Examples of events that trigger a non-viability condition as specified by the BOT may include scenarios where (1) the bank's assets are insufficient to pay off depositors and creditors; (2) the bank's capital weakens to a level that may detrimentally affect depositors and creditors; (3) the bank is unable to recapitalize on its own.

Fig.1: Rating notch-down on bank hybrid capital instruments

	Notch-down from ICR	AT1 Deductible notches	Tier-2 Deductible notches
(1) Contractual subordination	1 notch from ICR of BBB- or above; otherwise, 2 notches	1 to 2	1 to 2
(2) Risk of partial or untimely payment	1 notch for Tier-2 instruments with coupon-deferrable features		1
	2 notches for AT1 subject to Basel III	2	
(3) Mandatory contingent capital leading to equity conversion or capital write-down (or both)	1 notch* for going-concern or non-viability contingent capital (NVCC) clauses	1	1

* *No deduction if: (a) expect pre-emptive support from authorities; (b) expect authorities not to enforce contingent capital clause*

Appendix A: Additional Tier-1 Capital Instrument

Proceeds	Issued and fully paid up
Maturity	Perpetual
Loss absorption	Going-concern basis 1) Conversion into common shares when CET1 ratio falls below trigger point (CET1 > 5.125%) or 2) Principal write-down when CET1 falls below trigger point (CET1 > 5.125%) The conversion and write-down must satisfy the following: - Reducing claim of AT1 holders or reducing the principal to be paid in redemption/ interest payment - Resulting in capital increase (higher CET1) based on accounting standards - Amount of conversion or write-down must be at least equal to the amount needed to keep CET1 ratio above trigger point, otherwise in full Gone-concern basis (at the point of non-viability) 1) Conversion into common shares or 2) Written off when authorities decide to provide financial assistance
Seniority of claim	Junior to preferred creditors, depositors, general creditors, subordinated debt, and Tier-2 instruments
Security	Unsecured / Unguaranteed / Uninsured
Call/ Redemption Repurchase	Banks shall not create an expectation that the instrument would be repurchased or redeemed before maturity Redemption after 5 years from issue date, only when: - Approved by the BOT (redemption plan submitted at least 30 days in advance) - Banks commit to replace it with instrument of equal or better qualifications immediately or prior to redemption - Such redemption will not result in capital ratio falling below minimum requirement Redemption before 5 years is possible when there are changes in: - Tax legislation causing changes in tax benefits - Capital requirement regulations resulting in AT1 instrument being disqualified for inclusion in Tier-1 capital Repurchase - Approved by the BOT (banks are to submit repurchase and replacement plan for the instrument on a case-by-case basis) - Repurchase of preferred shares included in Tier 1 is considered an indirect capital decrease, which requires BOT approval - Banks must comply with accounting standard regarding repurchase of financial instruments included in Tier 1

Interest payment	- Banks have full discretion at all times to cancel payment - No provisions that require banks to pay interest if dividend is paid to equity holders (dividend pusher) - If interest on Tier-1 instruments is not paid, banks cannot pay dividend to equity holders (dividend stopper) - Interests are noncumulative - Non-payment is not considered an event of default - Banks have rights to cancel payments if they need to meet other debt obligations - Banks are allowed to pay interest without prior approval from the BOT but must have sufficient retained earnings and do not breach regulatory capital requirements - Conditions for partial interest payment must be specified in prospectus

Source: Bank of Thailand (Notification of Bank of Thailand No. FPG 22/2563)

Appendix B: Tier-2 Capital Instrument

Proceeds	Issued and fully paid up
Maturity	Original maturity = min 5 years; last 5 years amortized on a straight-line basis
Loss absorption	At the point of non-viability, there shall be provisions on a gone-concern basis that the instrument 1) will be converted into common shares or 2) will be written off when authorities decide to provide financial
Seniority of claim	Junior to preferred creditors, depositors, general creditors
Security	Unsecured / Unguaranteed / Uninsured
Call/ Redemption Repurchase	Banks shall not create an expectation that the instrument would be repurchased or redeemed before maturity Redemption after 5 years from issue date, only when: - Approved by the BOT (redemption plan submitted at least 30 days in advance) - Banks commit to replace it with an instrument of equal or better quality immediately or prior to redemption - The early redemption will not result in capital ratio falling below minimum requirement - Ensure that redemption does not cause capital ratio to fall below 9% Redemption before 5 years is possible when there are changes in: - Tax legislation causing changes in tax benefits - Capital requirement regulations resulting in instrument being disqualified for inclusion in Tier 2 capital Repurchase - Approved by the BOT (banks are to submit repurchase and replacement plan for the instrument on a case-by-case basis) - Repurchase of preferred shares included in Tier 2 is considered an indirect capital decrease, which requires BOT approval - Banks must comply with accounting standard regarding repurchase of financial instruments included in Tier 2

Source: Bank of Thailand (Notification of Bank of Thailand No. FPG 22/2563)

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