

MARC ANALYTICAL INSIGHTS



RECENT DEVELOPMENTS IN RATING OF HYBRID SECURITIES

INTRODUCTION

Hybrid securities are defined as instruments that contain both debt-like and equity-like features. The key difference between hybrid securities and conventional debt instruments such as senior unsecured medium term notes is the ability of hybrid securities to absorb losses without triggering a default by the issuer. This loss absorbing feature enables hybrid securities to be assigned equity credit in regulatory capital adequacy computations. This together with the tax deductibility of interest expenses have been key drivers for hybrid securities gaining popularity among issuers in the financial institutions space.

The most common loss absorption feature embedded in hybrid securities is coupon deferral, which includes both cumulative coupon deferral and non-cumulative coupon omission. Other more extreme mechanisms include principal write-downs and conversions to a more deeply subordinated instrument such as equity or equity-like instruments such as preference shares. In the case of financial institutions, only those instruments that have non-cumulative interest omission are considered as Tier 1 capital.

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HYBRID SECURITIES IN MALAYSIA

In the case of Malaysia, existing regulations set by Bank Negara Malaysia (BNM) broadly recognise two classes of hybrid securities: non-cumulative hybrid securities, which are treated as Tier I capital instruments, and cumulative hybrid instruments, which are treated as Tier II instruments. Non-cumulative hybrids are further sub-divided into non-innovative and innovative instruments, largely based on the availability of features such as interest rate step-ups and limited call provisions. The salient features of these instruments are summarised below.

FEATURES	NON-INNOVATIVE TIER 1 CAPITAL INSTRUMENTS (NON-IT 1)	INNOVATIVE TIER 1 CAPITAL INSTRUMENTS (IT1)	HYBRID TIER II CAPITAL INSTRUMENTS
Seniority	Senior only to ordinary shares	Senior only to equity shareholders, including non-IT1 instruments, namely perpetual preference shares	Senior to IT1 instruments, but subordinated to other subordinated debts
Maximum capital benefit available	Maximum of 35% of eligible Tier I capital (net of goodwill). If no IT1 instruments are issued then this limit is expanded to 50%	Shall not exceed 15% of eligible Tier 1 capital (net of goodwill)	Shall not exceed 50% of eligible Tier 1 capital
Redemption	Callable by the issuer only after 5 years from issue date and subject to BNM approval		Not redeemable at the initiative of the holder
Type of interest deferral	Non-cumulative	Non-cumulative. However, interest/dividend payment through stock settlement is allowed on a case-by-case basis	Service obligation can be deferred where the issuer's profitability would not support payment
Deferral trigger	Not explicitly mentioned, but it is expected that optional deferral is possible as long as ordinary dividends are not paid	Optional deferral is possible as long as interest or dividends due for securities junior to the IT1 instruments are not paid	Not applicable
Interest rate step-up	Not allowed	One step up over the life of the instrument no earlier than 10 years from issue and the step up rate is fixed as specified by BNM, but no greater than 100bps. This has to be pre-set at the time of issuance	Not applicable
Other loss absorption features	Not applicable	Mandatory conversion from debt to equity will occur when the minimum Risk Weighted Capital Adequacy Ratio (RWCR) is breached, on commencement of winding up of the issuer or upon the appointment of an administrator to the bank.	Should be available to participate in losses without the banking institution obliged to cease trading.

Source: Bank Negara Malaysia, MARC

RECENT REGULATORY DEVELOPMENTS

Until recently, hybrid securities have proven to be popular due to their comparatively lower costs. This also influenced regulatory requirements, which were drafted favouring the issuance of hybrid securities. Although the regulatory minimum Tier 1 capital ratio was 4% in most developed markets, hybrid securities were allowed to be as high as 50% of Tier 1 capital. This effectively resulted in a core capital ratio (exclusive of hybrids) of 2%, as compared to a minimum regulatory required Tier 1 capital ratio (inclusive of hybrids) of 4%. However, in the aftermath of the global financial crisis, regulators have begun to express doubts on the effectiveness of hybrid securities in absorbing losses in a going concern as credit losses and write-downs were made from the banks' retained earnings, which then resulted in lowering their tangible common equity position.

In this light, the Basel Committee on Bank Supervision (BCBS) has already embarked on overhauling the existing Basel II regulations. In a consultative paper published in December 2009, the committee emphasised the need to strengthen the banks' Tier 1 capital base so that it can fully absorb losses on a going concern basis. Hence BCBS has proposed that Tier 1 capital to be predominantly composed of common shares and retained earnings as opposed to the current regulations, where such common equity and reserves can account for as little as 50% of Tier 1 capital. The BCBS also views that any other Tier 1 capital component must be subordinated, have fully discretionary non-cumulative dividends or coupons and have neither a maturity date nor an incentive to redeem. At the same time BCBS has also stated that innovative hybrid capital instruments with an incentive to redeem through features like step-up clauses, currently limited to 15% of the Tier 1 capital base, will be gradually phased out.

MARC expects the emerging international regulations to influence domestic banking regulations on hybrid securities. As of September 2009, MARC notes that the nine local commercial banking groups (which account for 70% of banking sector assets) reported that on average, core equity constituted 82% of Tier 1 capital. However, there were some notable variations with four banks reporting core equity in excess of 100% of Tier 1 capital, while another four banks reported a core equity component which was less than 80% of Tier 1 capital. The ninth bank reported core equity-to-Tier 1 capital in the range of 80%-90%. While Malaysian banks are in a much better position than their peers in the developed world, the possible changes in regulations are nevertheless still likely to require Malaysian banks to further augment their core equity position.

RECENT DEVELOPMENTS IN RATING METHODOLOGIES FOR HYBRID SECURITIES

Given the higher risk profile of hybrid securities, which are deeply subordinated with a low likelihood of recovery, internationally, rating agencies have typically been notching them at least 2-3 notches down from the anchor rating assigned to the issuing financial institutions. Instruments with more aggressive loss absorption mechanisms such as permanent write-down of capital and contingent conversion of debt into equity have been often notched down wider.

The notching is done based on the issuer's anchor rating or its equivalent (i.e. Financial Institution Rating). In most cases the eventual anchor rating also included notching up for potential support from the government and/or the regulators as is the case in Malaysia. When assigning financial institution ratings for Malaysia-domiciled banks on a selective basis, MARC assumes support for a financial institution based on, among others, systemic importance to the economy, strategic importance to the government, interconnectedness with the financial system and substitutability of a financial institution within the broader financial system.

In the aftermath of the financial crisis, hybrid securities in some instances were subject to coupon suspension, principal write-down and distressed exchanges. Thus, some global rating agencies have sought to modify their hybrid securities rating methodology by stripping out support uplift assigned to the issuer's anchor rating, thus using an unsupported anchor rating for notching purposes. In addition, they have also widened the notching differences based on the instrument's features to better reflect loss severity. The use of an unsupported anchor rating and widened notching from the unsupported anchor rating has in some cases resulted in multiple notch downgrades of hybrid securities in the international arena.

MARC'S FINANCIAL INSTITUTION DEBT RATING METHODOLOGY

MARC's notching policy for debt instruments, including hybrid securities, remains unchanged despite the recent proposed changes in regulatory treatment of hybrid securities as well as methodological changes by other rating agencies. The notching is done using the financial institution rating (FIR) as the anchor rating. MARC's standard notching policy for debt instruments issued by financial institutions is given in the following table.

INSTRUMENT	NOTCHING DOWN FROM FIR	
	<i>FIR of AA- or greater</i>	<i>FIR of A+ or lower</i>
Senior Unsecured Debt	Equal to FIR	One notch down from FIR
Subordinated Debt	One notch down from FIR	Two notches down from FIR
Hybrid Securities	Two notches down from FIR	Three notches down from FIR

As the table above illustrate, MARC's notching policy remains conservative, with wider notching applied for entities rated A+ or below. This approach is consistent with local market perceptions of risk as reflected by the steep difference in bond yields for entities rated below the AA rating band.

MARC's financial institution rating also encapsulates possible support that can be extended by the authorities. Unlike the global rating agencies which have chosen to notch down debt ratings from the unsupported FIR, MARC does not view that such a differentiation is necessary because the agency's financial institution ratings reflect its objective assessment of a financial institution's fundamental credit risk profile. Where appropriate, only a limited degree of sovereign support is considered, and that too only on a case-by-case basis as merited by each institution's unique circumstances.

In other words, MARC does not assume blanket support for the entire banking system as this can result in rating inflation and eventually affect the informational and credit risk management value that credit ratings are expected to contain. Furthermore, MARC's rating approach ensures that MARC's universe of rated financial institutions is more reflective of the institution's intrinsic credit quality, thus minimising the need to normalise the FIR to factor-out support when rating a hybrid security.

As for the entities for which MARC assumes regulatory support, the agency opines that such support is likely to be forthcoming in view of their importance to the national economy and in the interest of maintaining general economic confidence. Given the government's desire to maintain economic confidence and financial system stability, it is very likely that it would support a systemically important bank in distress. The unprecedented scale on which the Malaysian authorities engaged in expansionary fiscal and monetary policies as well as countercyclical regulatory policies during 2008/09 clearly underscores their commitment to maintain economic confidence and financial system stability.

CONCLUDING REMARKS

MARC will continue to monitor both local and global regulatory developments as well as market practices that may influence the regulatory and analytical treatment of hybrid securities. The agency will revisit its methodology and make relevant refinements to its methodology as necessitated by those developments. For now, MARC maintains its hybrid rating methodology for financial institutions.

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