RATING METHODOLOGY

APPROACH TO RATING BASEL III – COMPLIANT CAPITAL INSTRUMENTS

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BACKGROUND

In December 2010, the Basel Committee on Banking Supervision released a set of reform measures (Basel III) to strengthen the regulation, supervision and risk management of the banking sector, as set out in 'Basel III: A global regulatory framework for more resilient banks and banking systems'. A major focus of the measures is to strengthen global capital rules for financial institutions, as reflected in Basel III's stricter eligibility criteria for hybrid capital instruments for inclusion in Tier 1 and Tier 2 capital as well as the requirements to maintain capital conservation and countercyclical buffers. A revised version of the capital framework was subsequently published in June 2011.

To protect the integrity of the banking sector's capital, an objective of the international regulator's enhanced capital framework is to ensure that capital is available to absorb losses in a gone-concern scenario or leading up to that point. Basel III Additional Tier 1 capital instruments are fully loss-absorbent on a going concern basis and play a role in preserving the bank as a going-concern. Basel III Tier 2 capital instruments, meanwhile, absorb losses on a winding-up basis and provide a capital cushion to depositors and senior creditors in bankruptcy or liquidation.

The main objective of this methodology piece is to outline the general notching guidelines that MARC will apply to issues of Basel III-compliant bank capital instruments to reflect their higher loss absorption capacities compared to their Basel II predecessors.

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MARC RATINGS' NOTCHING POLICY

MARC Ratings' general approach to rating various classes of debt and hybrid securities issued by a financial institution is to notch down from the issuer's long-term Financial Institution (FI) rating. The FI rating incorporates explicit or implicit external support for the financial institution in the form of institutional support from the financial institution's shareholder(s), and systemic external support where the institution is assessed to be systemically important. In cases where the FI rating has benefited from meaningful rating uplift on account of systemic external support, the notching from the FI rating could be wider than that indicated by MARC Ratings' notching guidelines. This would likely be the approach taken where the rated capital instrument has going concern loss absorption characteristics as in the case of Basel III-compliant Additional Tier 1 capital instruments, in which case the instrument is unlikely to benefit from systemic support.

Bank capital instruments represent junior claims on the funds and assets of the bank relative to those of senior debt and are also potentially subject to deferral of dividend or interest payments in the case of capital instruments with coupon/dividend deferral features. Where coupon/dividend deferral features are absent, the notching differential between the FI rating and the instrument rating primarily reflects subordination and any additional risk posed to the instrument holder in terms of loss severity by other loss-absorbency features of the instrument. In the case of capital instruments with coupon/dividend deferral features, additional notching is implemented to reflect the coupon/dividend deferral risk. MARC distinguishes deferral risk from default or insolvency risk, which is adequately captured by the bank's FI rating.

Generally, notching narrows at higher rating levels and widens at the lower end of the scale due to significantly higher risk of coupon deferral on deferrable instruments in addition to higher expected loss severity in the event of a winding-up scenario for FIs rated lower on financial strength.

RATING APPROACH FOR BASEL III BANK CAPITAL INSTRUMENTS

MARC Ratings' general notching policy for non-Basel III-compliant hybrid capital instruments issued by financial institutions is provided in Exhibit 1a below and is also found in MARC's Analytical Insights titled 'Recent Developments in Rating of Hybrid Securities'. Non-qualifying capital instruments issued prior to September 12, 2010 will generally be phased out over a period of up to 10 years with capital recognition being reduced by 10% a year during this period, subject to the instrument remaining outstanding and subject in certain circumstances to no call date occurring in respect of the instrument. The innovative and dated hybrid instruments allowed under Basel II are not allowed under Basel III.

MARC has not revised its general notching guidelines for these instruments but takes note of the global and prudential trends towards burden sharing between the national authorities and bank creditors. The rating agency will continue to monitor the evolving risk profile of outstanding non-Basel III-compliant capital instruments it rates to ensure assigned ratings continue to reflect the fundamental characteristics of these instruments.

Exhibit 1a: Notching guideline for ratings for non-Basel III-compliant capital instruments

Instrument	Notching down from FI rating	
	FI rating of AA- or greater	FI rating of A+ or lower
Tier 1 capital instruments	Two notches down from FI rating	Three notches down from FI rating
Tier 2 capital instruments	One notch down from FI rating	Two notches down from FI rating

Exhibit 1b: Notching guideline for ratings for Basel III-compliant capital instruments

Instrument	Notching down from FI rating		
	FI rating of AA to AAA	FI rating of A to AA-	FI rating of A- or lower
Additional Tier 1 capital instruments	Three notches down from FI rating	Four notches down from FI rating	Five notches down from FI rating
Tier 2 capital instruments	One notch down from FI rating	Two notches down from FI rating	Three notches down from FI rating

A major new requirement for Basel III-compliant Additional Tier 1 and Tier 2 capital instruments, as announced by the Basel Committee on January 13, 2011, is that they must now contain provisions to ensure that losses are fully absorbed by the instruments at the point of non-viability (PONV). Loss absorbency is to be achieved by way of permanent write-down of the instrument's principal or its conversion to equity. PONV is either: a decision that a write-down/conversion is necessary, without which the institution would become non-viable; or a decision to make a public sector injection of capital, or provide equivalent support, without which the financial institution would become non-viable.

Additionally, Basel III requires the principal amount of the Additional Tier 1 capital instrument to be written down, or the instrument to be converted to common equity, upon the occurrence of a trigger event. The inclusion of a non-viability trigger for Tier 2 capital instruments will allow the domestic regulator to require the instrument's conversion into common equity or to require its write-off.

Additionally, there is now a prohibition on the inclusion of step-up provisions that require the bank to increase the coupon rate if the security is not redeemed by a certain date and other provisions which act as incentives for the issuer to redeem the instruments. The prohibition on issuer incentives to redeem is intended to increase the permanency of Basel III - compliant Additional Tier 1 and Tier 2 capital instruments.

Exhibit 2: Qualifying criteria for Basel III Compliant Additional Tier 1 and Tier 2 Capital Instruments

Features	Tier 1 capital (additional going-concern capital)	Tier 2 capital (gone-concern capital)
Term	Perpetual, no step-ups or other incentives to redeem.	Minimum original maturity of at least 5 years. No step-ups or other incentives to redeem.
Redemption/ repayment	Repayment of principal only with prior supervisory approval.	Investor must have no rights to accelerate repayment of future scheduled payments except in bankruptcy or liquidation.
Call	i) Callable by the issuer only after a minimum of five years. ii) To exercise call option, the bank must receive prior supervisory approval. iii) The bank must not do anything to create an expectation that the call will be exercised. iv) The call must not be exercised unless: the bank replaces the call instrument (concurrent with call) with capital of same and better quality and replacement is done at conditions sustainable for income capacity of bank; or the bank demonstrates a capital position well above domestic regulatory requirements.	
Distributions/ Coupons	i) Bank must have full discretion at all times to cancel distributions or payments. ii) Cancellation of discretionary payments must not constitute an event of default. iii) Banks must have full access to cancelled payments to meet obligations as they fall due. iv) Cancellation of distributions or payments must not impose restrictions on bank except in relation to distributions to ordinary shareholders.	Investors must have no rights to accelerate repayment of future scheduled payments (coupon or principal), except in bankruptcy or liquidation.
	Additional Tier 1 capital and tier 2 capital instruments may not have a credit sensitive dividend feature, i.e. dividend/coupon that is reset periodically based in whole or part on bank's current credit standing.	
Subordination	Subordinated to depositors, general creditors and subordinated debt of bank.	Subordinated to depositors and general creditors of bank.
Loss absorption features	Must be written off or converted to equity at a pre-specified trigger point	Must be written off or converted to equity at the determination of the relevant supervisor either that the bank would not be viable without the write-off or that a public sector capital injection is to be made.

Similar to the notching practice for MARC Ratings' notching guidelines for non-Basel III-compliant capital instruments, the rating agency uses the FI rating as a reference point for determining the ratings on Basel III-compliant capital instruments. The minimum notching is one notch for Tier 2 instruments and three notches for Additional Tier 1 instruments. It is expected that the majority of assigned ratings on Basel III capital instruments will conform to these guidelines. Certain exceptions will, however, be made where MARC believes the terms of the rated capital instrument and/or discretions exercised by national supervisory agencies with regard to the application of the Basel III reforms materially increase or reduce the investor's expected loss severity and coupon/dividend interruption risk relative to that encapsulated in the notching recommendations. MARC Ratings' notching guidelines assume that the rated instruments have full and permanent write-down features.

MARC Ratings' notching guideline for Basel III-compliant capital instruments reflects higher expected relative loss severity and coupon/dividend interruption risk notching for Additional Tier 1 capital instruments as compared to their Basel II predecessors. The higher expected loss severity for Basel III-compliant regulatory capital instruments derives from the view that governments are unlikely to provide any support for such instruments, going forward. The additional loss absorption requirements for Additional Tier 1 and Tier 2 instruments have been introduced by the Basel Committee in light of the fact that during the 2008 global financial crisis, the Tier 2 capital instruments and in some cases Tier 1 instruments of a number of distressed financial institutions did not contribute to absorbing the losses that had been incurred, which they would have done if these institutions had been allowed to fail rather than rescued through the injection of public funds. Of rating significance will be the circumstances in which the regulator concerned would determine that the point of non-viability has been reached.

MARC is of the view that coupon/dividend interruption risk for Basel III-compliant Additional Tier 1 capital instruments is significantly higher as compared to non-Basel III-compliant Tier 1 capital instruments. The financial institution has full discretion at all times to cancel coupon/dividend payments on Basel III-compliant Additional Tier 1 capital instruments. There is no requirement to repay omitted payments. Additionally, dividend pusher provisions which were previously allowed for hybrid Tier 1 instruments are now prohibited under Basel III, as is the requirement for a financial institution to make a distribution/payment in kind (e.g. in shares) where it elects not to pay in cash. The aforementioned changes from the Basel II qualifying criteria improves the loss absorbency of the Tier 1 capital instruments on a going-concern basis by increasing the likelihood that dividends or coupons will be reduced or cancelled in times of stress as a result of the restrictions on distributions that apply through the imposition of capital conservation buffer requirements.

(Basel III introduces a capital conservation buffer of 2.5%, comprised of Common Equity Tier 1 (CET1), above the regulatory minimum capital requirement. The closer the financial institution's CET1 is to the required minimum, the more constrained the institution's ability to distribute dividends and coupons will become.)

MARC Ratings' notching recommendations vary depending where the issuer's FI rating is located on the rating scale; the Additional Tier 1 instrument will be rated three notches below the FI rating for an issuing financial institution with a FI rating of AA and above, four notches below the FI rating for an issuing financial institution with a FI rating between A to AA- and five notches for an issuing financial institution rated A- and below. The wider notching relative to Basel II predecessors reflects the fact that Basel III-compliant Additional Tier 1 instruments are designed to absorb losses while the financial institution remains a going concern. They have fully discretionary non-cumulative dividends or coupons, and have neither a maturity date nor an incentive to redeem. Qualifying Additional Tier 1 instruments under domestic regulator Bank Negara Malaysia's (BNM) Capital Adequacy Framework are required to have a write-off or conversion provision that will be triggered when the issuing financial institution's CET1 ratio reaches 5.125%. The Additional Tier 1 capital instruments have to be written off or converted to an amount sufficient to restore the CET1 Capital Ratio back to 5.75%. BNM requires all principal write-downs to be permanent.

For rating categories above AA, MARC Ratings' notching guidance for Basel III-compliant Tier 2 capital instruments with no coupon deferral flexibility is the same as that employed for Tier 2 capital instruments under Basel II. Given the absence of coupon deferral flexibility, loss absorption is not expected to occur until the financial institution is close to reaching the PONV. Accordingly, the rating differential between the FI rating (which represents the bank's senior unsecured rating) and the Basel III-compliant Tier 2 capital instruments primarily reflects expected relative loss severity. MARC has introduced additional notching for Tier 2 capital instruments rated A- and below compared to their Basel II predecessors to reflect their higher risk of principal loss through forced conversion into equity or write-off with the inclusion of a PONV trigger coupled with full and permanent write-down features.

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