

RATING METHODOLOGY

APPROACH TO RATING BASEL III – COMPLIANT CAPITAL INSTRUMENTS

The logo for MARC Ratings, featuring the word "MARC" in a bold, red, serif font, centered between two horizontal blue lines.

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 (AT1) 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.

This methodology outlines the general notching guidelines that MARC Ratings will apply to issues of Basel III-compliant bank capital instruments to reflect their higher loss absorption capacities compared to their Basel II predecessors.

Contact:

Elmer Lim
Head, Ratings Portfolio – Financial
Services
elmer@marc.com.my

+603 2717 2900
www.marc.com.my

This document is effective April 2025 supersedes the previous "Approach to Rating Basel III-Compliant Capital Instruments" methodology document.

MARC RATINGS' NOTCHING GUIDELINES

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.

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 Ratings 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 for Basel III-compliant hybrid capital instruments issued by FIs is provided in Exhibits 1 and 2 below.

Exhibit 1: Notching guidelines for ratings for Additional Tier 1 capital instruments

FI rating	CET 1 capital buffer above loss absorbency threshold *		
	Above 5%	2% to 5%	Below 2%
FI rating of AAA to BBB-	Three notches down from FI rating	Four notches down from FI rating	Five notches down from FI rating
FI rating of BB+ or lower	Four notches down from FI rating	Five notches down from FI rating	Six notches down from FI rating

* Applied notching considers a forward view of an institution's capital position and strategy, where its CET 1 capital buffer is close to our notching thresholds

CET 1 – Common Equity Tier 1

Exhibit 2: Notching guidelines for ratings for Tier 2 capital instruments

FI rating	General notching
FI rating of AAA to BBB-	One notch down from FI rating
FI rating of BB+ or lower	Two notches down from FI rating

By default, MARC Ratings' approach to rating Basel III-compliant capital instruments for FIs begins with applying a one-notch differential for institutions rated BB+ or lower, compared to those rated BBB- or higher. This notching differential reflects our view of increased credit risk with respect to the capital instruments of institutions in the lower rating group. Aside from the FI rating, our notching guidelines reflect three components:

- i) Coupon deferral risk
- ii) Subordination
- iii) Likelihood of loss absorbency trigger

Coupon flexibility

For AT1 capital instruments, an FI has full discretion to cancel coupon/dividend payments, with no requirement to repay omitted payments. We apply downward notching of one notch for AT1 instruments to reflect the risk of interruption in coupon/dividend payments.

Subordination

MARC Ratings applies downward notching to reflect the deeper subordination of Basel III-compliant capital instruments in relation to other creditors of an FI. Tier 2 capital instruments require the instrument's conversion into common equity or either its partial or full write-off upon the occurrence of a non-viability (i.e. gone concern) trigger event, placing them subordinate to depositors and general creditors of an institution, which include senior and unsecured bondholders.

AT1 capital instruments display deeper subordination as they feature similar loss absorbency as Tier 2 instruments but on a going concern basis. AT1 instruments are subordinate to other holders of the institution's subordinated debt, which includes Tier 2 instruments. To recognise the subordination of Basel III-compliant capital instruments, we notch AT1 instruments downward by two notches and Tier 2 instruments by one notch.

Likelihood of loss absorbency trigger

Bank Negara Malaysia's (BNM) Capital Adequacy Framework requires AT1 capital instruments to have a write-off or conversion provision that will be triggered upon the issuing institution breaching a specified CET 1 ratio (trigger threshold), which must be no lower than 5.125%. In a trigger event, the institution's AT1 capital instruments have to be written off or converted to an amount sufficient to restore the CET 1 Capital Ratio back to 5.75%.

We refer to an institution's CET 1 capital buffer, reflecting the distance of its capital level from its AT1 instrument trigger threshold, to determine the likelihood of loss absorbency being exercised. A lower buffer would be indicative of heightened credit risk, which we address by applying a one-notch downgrade if the institution's buffer falls below 5%, and an additional one-notch downgrade if the buffer further falls below 2%. Where an institution's CET 1 buffer is close to

our thresholds for additional notching, we may apply judgment in accelerating or deferring changes based on our notching guidelines, by considering a forward view of an institution's capital position and strategy.

Tier 2 instruments do not receive further notching from this component as we believe a non-viability trigger event is closely linked to a credit default event, which is reflected in the FI rating we assign to an institution.

Exhibit 3 below provides more details on the characteristics of Basel III-compliant AT1 and Tier 2 capital instruments.

Exhibit 3: Qualifying criteria for Basel III-compliant Additional Tier 1 and Tier 2 capital instruments

Features	Additional 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 five 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 the 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.

	AT1 capital and Tier 2 capital instruments may not have a credit sensitive dividend feature, i.e. dividend/coupon that is reset periodically based in part or in whole on the 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

ADDITIONAL CONSIDERATIONS TO BASEL III CAPITAL INSTRUMENT RATINGS

It is expected that MARC Ratings' assigned ratings on Basel III capital instruments will largely conform to these guidelines. Certain exceptions will, however, be made where MARC Ratings believes the terms of the rated capital instrument 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.

Additionally, in situations where we believe loss absorbency is imminent or has greater certainty of being triggered for a Basel III capital instrument, we may elect to assign a rating below investment grade (below BBB-) in divergence from our notching guidelines in Exhibit 1, to appropriately reflect the increased credit risk. Conversely, for an institution's Basel III capital instrument that would otherwise be notched downward due to eroded capital buffer, we may defer a rating downgrade if we have knowledge of credible plans by the institution to avoid a loss absorbency trigger.

Disclaimer

Copyright © 2025 MARC Ratings Berhad and any of its subsidiaries or affiliates ("MARC Ratings") have exclusive proprietary rights in the data or information provided herein. This report is the property of MARC Ratings and is protected by Malaysian and international copyright laws and conventions. The data and information shall only be used for intended purposes and not for any improper or unauthorised purpose. All information contained herein shall not be copied or otherwise reproduced, repackaged, transmitted, transferred, disseminated, redistributed or resold for any purpose, in whole or in part, in any form or manner, or by any means or person without MARC Ratings' prior written consent.

This report is strictly confidential and privileged and is intended solely for the information and benefit of the addressee or recipient. If you are not the intended recipient, and/or have received this report in error, please delete this report and do not copy, disseminate, distribute or disclose the content of this report to any other person.

Ratings are solely statements of opinion and therefore shall not be taken as statements of fact under any circumstances. The information which MARC Ratings relies upon to assign its ratings includes publicly available and confidentially provided information obtained from issuers and its advisers including third-party reports and/or professional opinions which MARC Ratings reasonably believes to be accurate and reliable to the greatest extent. MARC Ratings assumes no obligation to undertake independent verification of any information it receives and does not guarantee the accuracy, completeness and timeliness of such information. MARC RATINGS OR ITS AFFILIATES, SUBSIDIARIES, DIRECTORS AND EMPLOYEES DISCLAIM ANY WARRANTY, EXPRESS OR IMPLIED, INCLUDING BUT NOT LIMITED TO ANY WARRANTY AS TO THE ACCURACY, COMPLETENESS OR TIMELINESS OF ANY INFORMATION CONTAINED HEREIN FOR ANY PARTICULAR PURPOSE AND SHALL NOT IN ANY EVENT BE HELD RESPONSIBLE FOR ANY DAMAGES, DIRECT OR INDIRECT, CONSEQUENTIAL OR COMPENSATORY, ARISING OUT OF THE USE OF SUCH INFORMATION. MARC will not defend, indemnify or hold harmless any user of this report against any claims, demands, damages, losses, proceedings, costs and/or expenses which the user may suffer or incur as a result of relying on this report in any way whatsoever. Any person making use of and/or relying on any credit analysis report produced by MARC Ratings and information contained therein solely assumes the risk in making use of and/or relying on such reports and all information contained therein and acknowledges that this disclaimer has been read and understood and agrees to be bound by it.

A credit rating is not a recommendation to buy, sell or hold any security and/or investment. Any user of this report should not rely solely on the credit rating and analysis contained in this report to make an investment decision in as much as it does not address non-credit risks, the adequacy of market price, suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security concerned.

Ratings may be changed, placed on MARCWatch, suspended or withdrawn at any time for any reason at the sole discretion of MARC Ratings. MARC Ratings may make modifications to and/or amendments in credit analysis reports including information contained therein at any time after publication as it deems appropriate.

MARC Ratings receives fees from its ratees and has structured reporting lines and compensation arrangements for its analytical members in a manner designed to promote the integrity of its rating process, and to eliminate and/or manage actual and/or potential conflicts of interest.

© 2025 MARC Ratings Berhad

Published and printed by:

MARC RATINGS BERHAD 202001041436 (1397757-W)
19-07, Level 19, Q Sentral, 2A Jalan Stesen Sentral 2, Kuala Lumpur Sentral, 50470 KUALA LUMPUR
Tel: [603] 2717 2900 Fax: [603] 2717 2920
Email: ratings@marc.com.my Website: www.marc.com.my