RATING METHODOLOGY

APPROACH TO RATING BASEL III – COMPLIANT CAPITAL INSTRUMENTS

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.

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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.

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