Bank Capital Instruments Rating Methodology

Financial Institutions

2 May 2022

Contacts

Pauline Lambert
p.lambert@scoperatings.com

Marco Troiano, CFA
m.troiano@scoperatings.com

Nicolas Hardy
n.hardy@scoperatings.com

Chiara Romano
c.romano@scoperatings.com

Christian van Beek
c.beek@scoperatings.com

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This is an update of our Bank Capital Instruments Rating Methodology (April 2021).

This update aligns the approach to rating long-term debt securities with that of the Financial Institutions Rating Methodology (January 2022). Notching of debt instruments, including capital securities, now starts from the issuer rating, which remains the cornerstone of our analytical work for both banks and non-bank financial institutions.

There are no subsequent rating implications for existing ratings assigned by Scope.

Scope of application

The Bank Capital Instruments Rating Methodology details our framework for assigning ratings to Additional Tier 1 and Tier 2 securities issued by banks.

This rating methodology applies solely to Basel III /CRD-CRR compliant capital securities. It does not apply to legacy hybrid securities issued primarily before the financial crisis and which Scope does not rate. While the methodology concerns capital securities issued by banks in the EU/EEA, Switzerland and the UK, the general framework should be broadly applicable to other regions and non-bank financial institutions issuing such securities. To be clear, this methodology would not be applicable to capital securities issued by insurance companies.

This methodology should be read in conjunction with the “Financial Institutions Rating Methodology” (January 2022) which details how financial institutions ratings are assigned.

1. Introduction

Scope considers the issuance and structure of capital securities to be driven by their primary role in strengthening capital positions. They are meant to provide a viable, private-sector alternative for recapitalising financial institutions, in addition to the issuance of equity. Consequently, both Additional Tier 1 (AT1) and Tier 2 capital securities are subject to principal loss-absorption risks. Furthermore, AT1 securities are exposed to coupon-cancellation risks. These risks underpin the basis of the rating methodology.

Scope highlights that for banks, unlike with other credit sectors, it is primarily regulatory action which leads to default-like situations. Examples include: (i) early supervisory intervention to prevent payments on capital securities and (ii) resolution-related debt bail-ins. Ratings must therefore assess the extent to which credit fundamentals and other factors evaluated through the rating process inform on this likelihood. Scope uses the term ‘default-like’ rather than ‘default’ as, (i) supervisory-intervention-induced non-payment on capital securities (coupons and/or principal), nor (ii) resolution-induced bail-in of eligible liabilities, could be considered *de jure* defaults, although the impact for investors may be similar to a default.

2. AT1 capital securities ratings

2.1 Due to coupon and principal risks: at least five notches down from issuer rating

Ratings on AT1 capital securities highlight the considerably greater risks associated with these securities compared to other liabilities, such as senior unsecured debt. Scope's approach to rating AT1 securities starts with the inherent coupon-cancellation and principal-loss-absorption risks that investors face when investing in these securities. More specifically, these are:

A. Coupon-cancellation risks

- Missing a coupon due to a lack of available distributable items (ADI)
- Missing a coupon as payment is at the issuer's discretion
- Missing a coupon or part of a coupon when the issuer does not meet its combined buffer requirement (CBR)

B. Principal-loss-absorption risks

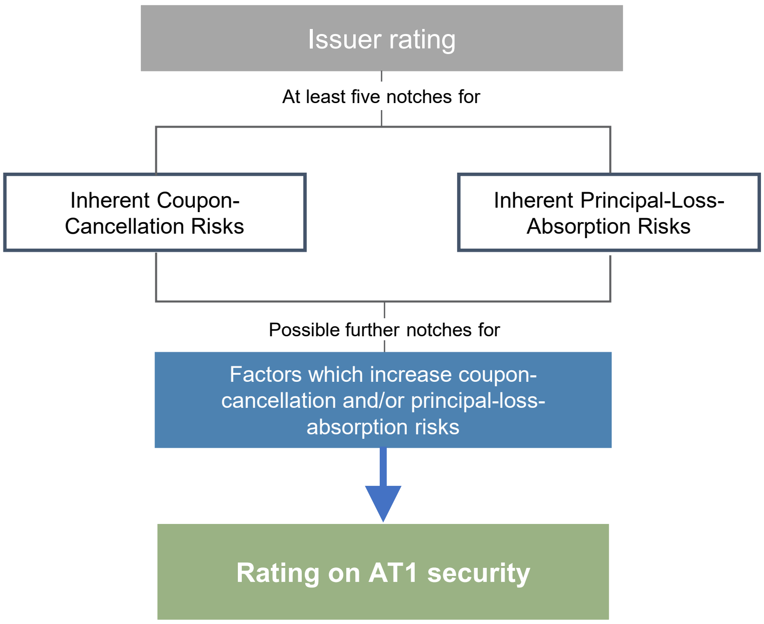
- Write-down or conversion when the relevant common equity Tier 1 (CET1) capital ratio breaches the specified trigger level
- Write-down or conversion when the issuer reaches the "point of non-viability" (PONV)

As a starting point for rating AT1 securities, Scope notches down at least five notches from the issuer rating.

Notching down reflects the deeply subordinated status of AT1 securities in the priority of claims, their going concern loss absorbing features and coupon-cancellation risks. When rating specific AT1 securities, there may be other distinct factors resulting in increased coupon-cancellation and/or principal-loss-absorption risks and, therefore, additional notching would be warranted.

Further, as an issuer's credit fundamentals weaken there may be additional notching as both coupon-cancellation and principal-loss-absorption risks become less remote.

Figure 1: Rating process for AT1 securities



Source: Scope Ratings

2.2 Factors which increase coupon-cancellation and/or principal-loss-absorption risks

As highlighted above, the minimum notching for AT1 capital securities is five notches to reflect their deep subordination and inherent coupon-cancellation and principal-loss-absorption risks. That said, the ratings on specific AT1 securities may be notched down further as Scope will also consider additional risk factors such as those detailed below. Some of these factors are security-specific while others are issuer-specific.

The following factors have been identified, but others may be added in the future as the securities continue to evolve. Scope takes the view that the rating methodology needs to be sufficiently flexible to address future, developments related to these securities. For example, the EU's bank risk reduction package from 2023 will link the ability of certain issuers to pay coupons to leverage ratio buffer requirements in addition to the current RWA-based capital requirements.

2.2.1 Specific factors for potential notching down

Trigger level

When looking at the absolute level of a trigger, Scope considers, all other things being equal, the higher the trigger, the greater the risk of a breach. In addition, Scope assesses the basis on which the CET1 trigger level is determined – for example, transitional or fully phased-in requirements or whether the trigger is applicable to the issuer or the consolidated group.

For example, a security with a 7% CET1 trigger level calculated on a fully phased-in CRD-CRR basis may warrant deeper notching, if the distance to trigger is relatively narrow or Scope estimates it will become so. To date, the market has generally considered AT1 securities with triggers above the minimum 5.125% required by CRR to be high trigger. Scope notes, however, that in the context of where capital requirements are currently, a 7% trigger is not high.

Distance to trigger level and combined buffer requirement

Scope evaluates an issuer's capital position relative to the trigger level and combined buffer requirement (CBR). Specifically, the distance to trigger level is relevant for assessing principal-loss-absorption risk, while the distance to the CBR is relevant for assessing coupon-cancellation risk. The distances to both the trigger level and CBR will fluctuate due to an issuer's operating performance, ability to generate capital and changing regulatory capital requirements or norms. Scope also considers how an issuer's distance to trigger level and CBR compares with other issuers.

For example, further notching may be warranted if Scope expects a material deterioration in the distance to CBR over the medium term. This may be the case as regulations increase asset risk weights or capital buffers.

Issuer-specific credit fundamentals

Scope considers areas in the issuer's fundamental assessment which may be comparatively more significant for the performance of the AT1 security than for its issuer rating in general. These may include capital generation capabilities, specific management targets for capital levels and buffers, and the stability and predictability of earnings. As well, while an issuer's overall credit fundamentals may benefit from external support, this is unlikely to be the case for its AT1 securities. Such considerations may justify deeper notching for AT1 securities.

For example, deeper notching for an AT1 security could be warranted if the risk of breaching the trigger or CBR were magnified by an issuer displaying significant conduct issues (and thus likely to incur significant financial penalties) or material earnings volatility stemming from a riskier business model.

Specific factors for potential notching down (continued)

Available distributable items
Coupons on AT1 securities are paid out of an issuer's distributable items (earnings and reserves), calculated on unconsolidated basis and often under local accounting standards. Scope, therefore, aims to identify risks related to where earnings are generated and how easily they can flow unimpeded to pay coupons. In addition, Scope assesses the magnitude and quality of available distributable items. For example, the share premium reserve available for distribution may depend on shareholder approval or be limited by national legislation.
Liability and capital structure
Scope considers which entity has issued the security and how the security is positioned within the group's liability and capital structure. This is particularly pertinent if there are other outstanding non-equity capital securities. If relevant, Scope also considers the cushion that other outstanding securities may provide.

3. Coupon-cancellation and principal-loss-absorption risks: a closer look

Scope sees the likelihood of coupon cancellation as materially less remote than the likelihood of principal conversion or write-down but considers that the magnitude of loss from principal conversion or write-down would be materially higher than from missed coupons.

3.1 Coupon-cancellation risks

As mentioned above, investors in AT1 securities may not receive a coupon or receive only a partial distribution due to issuer discretion or a breach of the CBR. In general, Scope does not believe that financially viable issuers with sufficient, available distributable items would willingly utilise this discretion because the potential reputational damage could be very significant and harm future market access. Further, before not paying coupons on AT1 securities, issuers have the discretion to cut bonuses and dividends.

Scope believes, however, that there may be a real risk of regulators influencing an issuer's discretion to make coupon payments on AT1 securities. Further, regulators may use their discretion under the supervisory process to restrict coupon payments. Such regulatory action occurred during the financial crisis and is very likely to occur again if warranted. In Scope's view, the most probable risk for AT1 investors is an issuer not making coupon payments because it does not meet its CBR.

Factors that may prevent an issuer from meeting the CBR include: (i) losses, (ii) unexpected provisions or charges related to litigation or conduct issues; (iii) a material increase in risk-weighted assets due to internal model changes or evolving regulatory requirements, (iv) an increase in the CBR due to changes in countercyclical capital-buffer rates or various systemic-risk buffer requirements and (v) material changes to Pillar 2 requirements. Accordingly, management intentions to maintain a buffer on top of required capital levels may provide some comfort for investors.

3.1.1 Impact of coupon-cancellation on AT1 ratings: no automatic downgrade

The CRD-CRR allows for coupon payment discretion on AT1 securities. Consequently, if an issuer does not pay AT1 coupons or pays only a partial coupon, it would not breach any regulatory or contractual obligations under the terms and conditions of the security and would therefore not be in default.

In this scenario, Scope will evaluate reasons for the coupon cancellation and assess whether this is a temporary or more permanent change in the issuer's ability to make future distributions. If the reason for the coupon cancellation were a one-off event, which does not impair the issuer's future capacity to make payments, Scope may not change the rating on the AT1 security. More specifically, Scope will not automatically consider such an event to be a default-like situation. However, if the reason were due to negative credit developments, such as a more permanent deterioration in the issuer's earnings capacity or an erosion of capital which is unlikely to be promptly restored, this would lead to a downgrade of the issuer rating and, potentially, a concomitant widening of the notching gap for the AT1 security rating.

3.2 Principal-loss-absorption risks

Under the terms of AT1 securities, write-down or conversion occurs when an issuer's CET1 capital ratio hits the specified trigger level, or the issuer has reached the PONV. Depending on the terms of the AT1 security, it may be written down on a permanent or temporary basis or be converted into equity.

Principal loss absorption when the contractual trigger level is breached is relatively straightforward to understand. However, the PONV is less clearly defined and remains subject to interpretation. It is our understanding that AT1 securities may be written down or converted in early regulatory intervention and before resolution – when supervisors decide that actions must be taken to remedy an issuer's deteriorating condition. The Supervisory Review and Evaluation Process (SREP) informs on this as well as other material events. A poor SREP result, substantial fines, significant deterioration in MREL and an unexpected loss of senior management could be factors that lead to early regulatory intervention.

Scope's AT1 ratings do not account for any potential recovery value following principal loss absorption. However, Scope acknowledges that the ultimate loss profile on AT1 securities upon principal loss absorption may vary according to the loss absorption mechanism: an AT1 security, which converts into equity, may mean lower potential losses for an investor, provided that the issuer recovers and its shares retain some value. With a temporary write-down, the value of an AT1 security may also recover over time. By contrast, with a permanent write-down, AT1 investors would suffer a full loss with no chance of recovery.

Credit ratings also do not factor in whether securities will be called by the issuer or what the interest reset rate will be although these are important investor considerations.

3.2.1 Impact of write-down or conversion on AT1 ratings

Under the CRD-CRR, the terms of AT1 capital securities must allow for write-down or conversion under certain conditions. In such a scenario, investors would experience a material loss on their principal investment and thus Scope would consider this to be a 'default-like' event.

When an AT1 security is converted into equity, Scope would withdraw the rating as it rates credit risk and not equity risk. Similarly, when an AT1 security is written down permanently, it ceases to exist, and the rating would also be withdrawn.

When an AT1 security is written down temporarily, Scope would continue to rate it as it remains outstanding. The rating on the temporarily written-down security would be kept at "D" because a situation materially similar to a default would have been identified. Scope would then monitor and modify the rating as appropriate – for example, as the likelihood of coupon payment or write-up evolves.

4. Tier 2 capital securities ratings

4.1 Risks different than for AT1 securities, but not entirely so

Scope's rating approach for Tier 2 capital securities considers that under the CRD-CRR framework, they rank above AT1 securities in the priority of claims, contain no discretion regarding coupon payments, and do not require a contractual trigger for write-down or conversion.

Nonetheless, as clearly stated under the Bank Recovery and Resolution Directive (BRRD), Tier 2 securities can be fully and permanently written down or converted when an issuer has reached the PONV, and before any other resolution action is taken. Consequently, investors in Tier 2 securities are exposed to principal-loss-absorption risks, whether there is a contractual trigger or not.

4.2 Typically, three notches down from issuer rating

When rating Tier 2 securities, Scope will typically notch down three notches from the issuer rating to reflect their junior status in the priority of claims. In a bail-in scenario, Tier 2 securities are considered capital securities and rank below other subordinated and senior debt. As well, converting or writing down Tier 2 securities is a possibility in early regulatory intervention (a step ahead of resolution), which is not the case with non-Tier 2 subordinated debt. This translates into Tier 2 securities being rated lower than non-Tier 2 subordinated debt.

When rating specific Tier 2 securities, there may be a possibility that further notching beyond the three is warranted. Following a rating approach similar to that used for AT1 securities, Scope considers whether there are additional risks due to the specific terms and conditions of the Tier 2 security or the issuer itself.

For example, the notching on a Tier 2 security may widen as an issuer's fundamentals deteriorate towards the PONV. Depending on the severity of the capital need and the amount of capital resources available, both AT1 and Tier 2 securities may be converted or written down.

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
23 Boulevard des Capucines
F-75002 Paris

Phone +33 6 62 89 35 12

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid
Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London

52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

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