Fitch Ratings

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
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17 February 2012

Dear Sirs,

Basel Committee on Banking Supervision
Consultative document
Definition of capital disclosure requirements – December 2011

We appreciate the opportunity to comment on the Basel Committee on Banking Supervision's (the Committee) Consultative document for the definition of capital disclosure (Consultative Document) published in December 2011. Fitch Ratings has been a strong advocate of the need for greater capital disclosure requirements for banks and welcomes efforts made to ensure that such reporting should be made in a consistent manner across jurisdictions.

Comparing the capital adequacy of banks across jurisdictions is of paramount importance to bank analysts. Calculations made to achieve this currently need be kept at a relatively high level, in part because published disclosure hampers analysts' ability to fine-tune the required adjustments. The Committee's proposal to ensure that banks comply with far more detailed disclosure, reported in a consistent manner, would therefore be helpful.

We note that the Basel capital ratios have two components. It is an important starting place to achieve good, consistent disclosure around the numerator, but we think that a more substantial leap forward in transparency would be achieved once more comprehensive and consistent disclosure is provided around risk weighted asset calculations as well.

Section 1: The use of templates across jurisdictions

A common template for banks to report the breakdown of their regulatory capital would be helpful. Bank investors and analysts compare information across banks in different jurisdictions. We consider the proposed requirement to complete a standardised template, as detailed in Annex 1 of the Consultative Document, to be the most helpful option. Templates impose consistency of presentation and detail and have proved to be the most straightforward tool to ensure analysts are in a position to compare and contrast information across jurisdictions.

We would like to see templates published on banks' websites at the same time and with the same frequency as financial statements are presented. It would be helpful to see the main items included in the management information sections of annual and interim reports.

We recognise that banks do not always find it easy to complete such templates. Many banks consider templates to be rigid and not sufficiently flexible to adequately capture the specific characteristics of capital instruments issued across different countries. Fitch understands these

limitations but, irrespective of this, the agency considers that a requirement to complete a template is by far the preferred option because it will ensure that a minimum of disclosure is provided by banks in a consistent manner. Should banks argue that templates are overly constraining, it might be helpful if they are given the flexibility to supplement the templates with detailed annotations.

Section 2: The need to reconcile regulatory capital disclosures to published financial statements

Bank investors and analysts make extensive use of banks' published financial statements, which generally form the cornerstone of financial analysis. Analysts also refer to all supplemental additional information, including regulatory disclosures and information provided under Basel II's Pillar 3 requirements. It is often difficult to understand the differences between the financial statements and regulatory information, even allowing for extensive discussion with the bank's management. The ability to refer to clear reconciliation tables would greatly assist analysts as they comment on the adequacy of bank capital.

Therefore, the proposal for banks to provide a detailed reconciliation of all regulatory capital elements back to published financial statements is welcomed by Fitch. The step by step approach detailed in the Consultative Document would provide a user-friendly tool, but we question whether the work involved in producing such a comprehensive reconciliation of the balance sheet would be justified by its usefulness. It is unlikely that many analysts would find much use for most of the line-by-line balance sheet items set out in Annex 2 for most banks.

We have not quite understood what the Basel Committee thinks such a detailed comparison would achieve. Investors and analysts would need some of this information to understand the common equity data in lines 1 to 6 of Annex 1, but total assets and total equity comparison would present this in most cases and give an indication of whether the differences were material enough to warrant further explanation.

The difference, as we understand it, would be the scope of consolidation. Investors and analysts will focus on material items only, and as long as investors and analysts have an understanding of 80-90% of the reconciliation, they do not need greater detail. We would therefore urge consideration of a materiality test for the balance sheet reconciliation. We consider that the following information would be of particular benefit to transparency around bank capital:

1. First and foremost, all assets and liabilities on the balance sheet excluded from regulatory capital (e.g. goodwill, certain deferred tax assets).
2. Entities consolidated in one balance sheet but not the other, which account for a material amount (for example, at least 5% or 10%) of assets or equity
3. Line items for the entities in 1 above, which account for a material amount of assets or liabilities.

Grouping companies by the nature of their business would be helpful, for example 'securitisation entities', 'insurance companies'. Explanations of material variation in the differences from current to prior period would also be helpful in analysis.

Transparency would be improved by the Committee's proposal to require banking groups to disclose the list of all legal entities included within the accounting scope of consolidation but excluded from the scope of the regulatory scope of consolidation and vice versa (paragraph 16 of the Consultative Document). This would help market participants to investigate the risks posed by unconsolidated subsidiaries. However, in order to make this more meaningful, we suggest that total assets and equity data are provided for all material companies on the list (for example those representing more than 5% or 10% of consolidated equity or assets). In these material cases, which we would expect to be rare, it would also be helpful to provide a link to any publicly available financial statements of these unconsolidated companies.

The 3 step approach does not address one of the difficulties investors and analysts have in building a bridge between financial statements in IFRS and regulatory capital data that use local GAAP as its base. More substantial disclosure from banks in jurisdictions where this is the case would add to market transparency.

Section 3: The main features template

The proposed description of the main features of capital instruments issued in a standardised template would be a helpful reference tool to investors and analysts. The proposal to require banks to provide a summary of the terms of these instruments will allow users to quickly identify the key characteristics of such instruments. We consider that summarising key features of these instruments will provide analysts and investors with a good understanding of the differences among them – be it within a bank, among banks in the same jurisdictions or, particularly, among banks across jurisdictions. Investors and analysts spend considerable time reading through the issue documents for these instruments, and the language is often complex and nuanced. Indeed it is our understanding that the issuing banks themselves have experienced uncertainty about "must pay" features in some instruments once these became relevant during times of stress.

As examples of how the features of these instruments are considered by investors and analysts, we attach criteria explaining Fitch's treatment of hybrids in bank capital analysis as well as criteria on ratings of the instruments themselves,

It would be helpful to have the main features template updated each time a capital instrument was issued and to have links to the respective prospectuses, which are not always publicly available and, when they are, can be difficult to locate. Investors and analysts would want to be able to extract total amounts from the template that reconcile to the most recent regulatory capital reporting numbers.

Amongst the list of features excluded from the template, Fitch notes that there are no special requirements detailed relating to capital instruments issued by non-joint stock companies. This may be because the Committee considers these to be outside its scope, but there are some important large European mutual banking groups, whose capital instruments can include unusual features. Fitch notes that certain capital instruments issued by non-joint stock companies which qualify as Common Equity Tier 1 (CET1) capital, and have been recognised as such by national regulators, include the potential for redemption in circumstances which generally do not comply with Basel III criteria for classification as common shares for regulatory capital purposes (as described in paragraph 53 of the 'Basel III: A global regulatory

framework for more resilient banks and banking systems' dated December 2010). In particular, some such instruments issued by non-joint stock companies may be redeemed at times other than in liquidation or winding up of the company and indeed, at the time when they are issued, may include a clause indicating that the instruments may be bought back, redeemed or cancelled within a given time frame.

Such buy backs, redemptions or cancellations may, for example, occur when the borrower, who has subscribed to the capital instrument at the same time as he took out a loan, has repaid his loans to the non-joint stock company. A requirement for non-joint stock companies to disclose the conditions for redemption of their CET1 capital instruments would be helpful for investors and analysts. This would assist analysts and other market participants to assess the permanence of CET1 capital at non-joint stock companies.

Section 4: Other disclosure requirements

The proposal to require banks to disclose a comprehensive explanation of how non-regulatory capital ratios are calculated (paragraph 36) would also be helpful to investors and analysts. The requirement (also in paragraph 36) for banks to make available the full terms and conditions of all instruments included in regulatory capital may already be captured under the disclosure required in Section 3 above.

The proposal to prohibit banks from using Basel III terminology loosely (paragraph 38) would also add to market transparency, or at least terminology should not be used without also providing a reconciliation to complete Basel III definitions. Market participants are confronted with references to "Basel-sounding' terminology used by banks in their publications, results presentations and public announcements. This can be particularly confusing as methodologies for calculating non-regulatory capital ratios, often preferred by management in their communication with the markets, are rarely disclosed.

It is true that disclosures required under Basel II's Pillar 3 have often proved difficult to uncover, becoming lost in the numerous pages of information provided (paragraph 39). The requirement to maintain an up-to-date Regulatory Disclosures section on banks' websites would be very helpful to bank investors and analysts. Indeed much of the detail around capital reconciliation could be included in this section rather than in financial reporting.

It is important that the templates presented by banks are as comprehensive as possible. Fitch does not consider any need to have the information included in the scope of the audit, as long as the data is reconciled to information that is audited. Best practice would be to include summary data considered by management as most relevant in the management reporting section of the annual and interim reports and the detail in a section of the website that can be easily located.

Section 5: Template during the transitional period

Proposals to ensure that disclosure during the transitional period (January 2014 – January 2018) is consistent and comparable across banks in different jurisdictions are welcomed by

Fitch. The Committee's proposals that banks should be able to use a modified version of an existing template, rather than having to develop a separate set of reporting requirements, appears sensible and should facilitate transitional period reporting for banks. However, it will be important for investors and analysts to have a template resembling the one in Annex 1 as soon as possible and a template along the lines of the example in Annex 4 would be a helpful way of getting there. It would be better to include a third column in this, showing 'fully loaded' Basel III numbers based on the current capital position.

We note that banks have started to report their own interpretations of 'fully loaded Basel III' ratios in various presentation formats, and data presented is inconsistent across banks and even in the same bank from one period to the next. It often includes estimates of retained earnings or risk-weighted asset reductions. It is important to work towards achieving better consistency as soon as possible, because this data will be a focal point for investors and analysts in the transition years.

Next step – disclosure around risk weighted assets

While we consider the Committee's efforts to ensure consistency of capital reporting for banks globally will aid market transparency around the ratios, the lack of disclosure surrounding how banks calculate their risk weighted assets (RWA) means that market participants would have, in effect, access to only half of the information which goes in to the calculation of regulatory capital ratios.

Fitch understands that a requirement for banks to disclose detailed information on their RWA calculations would be complex, particularly given the different approaches used by banks as they calculate these under Basel II. Nevertheless, a move towards greater clarity regarding calculations of RWAs going forward would improve transparency for investors in banks. Fitch considers that this would add much needed credibility to the RWA numbers produced among the investor and analytical community globally.

Yours faithfully

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Fitch Core Capital: The Primary Measure of Bank Capitalisation

Special Report

- This report updates and replaces Core Capital in Financial Institutions: The Fitch Perspective (March 2010.)

Related Research

EU Capital Requirements Directive (CRD) Retention Rule and Incentives in Securitisation (January 2010)

Bank Hybrid Securities - Debt Genes to the Fore During Financial Crisis (February 2011)

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Fitch Core Capital Key: Fitch core capital (FCC) is the primary measure used by Fitch Ratings analysts to assess a bank's capitalisation. In calculating FCC the agency's objective is to arrive at a figure, comparable across countries, measuring a bank's highest-quality, "going-concern" capital. FCC is broadly similar both to Basel III's Common Equity Tier 1 measure and Common Capital Tier 1 used in the US but it is not dictated by regulatory capital considerations and may differ from these.

FCC Tracks Capital Levels: Banks globally are addressing capital adequacy in the wake of the financial crisis that started in the late 2000s. Fitch believes FCC provides analysts and market participants with a useful tool for tracking absolute levels of bank capital in its purest, most loss-absorbing form across jurisdictions.

Highest Quality Capital: FCC comprises loss-absorbing, "going-concern" capital instruments (see below). FCC starts with equity reported in the bank's financial statements and deducts items that Fitch does not consider to be readily available to absorb losses in a stress scenario. This may be because they are not fungible, failed to perform as loss-absorbing instruments in the past or are difficult to monetise, or where inclusion introduces an element of double counting.

Keeping It Simple: Disclosure on items Fitch looks to adjust in deriving FCC is often limited. The FCC calculation is kept at a relatively high level, with a group of relatively simple adjustments to reported equity.

Fitch Eligible Capital Secondary: FCC excludes all hybrid capital instruments. Nevertheless, good-quality hybrid capital is still captured in an ancillary capital ratio, the Fitch eligible capital (FEC) ratio. FEC adds a bank's hybrid securities to FCC to the extent that they receive "equity credit". FEC represents a secondary measure of bank capitalisation for Fitch.

"Going", "Gone" Concern Capital: Attention is focused globally on the availability of capital that can help prevent a bank from becoming insolvent. References to "going" and "gone" concern capital are now frequent.

"Going concern" capital absorbs losses on a going-concern basis, allowing a bank to continue its activities and help prevent insolvency. This, in Fitch's opinion, is likely to become the preferred type of bank capital globally. "Gone" concern capital, which absorbs losses on a gone-concern basis, helping ensure that depositors and senior creditors can be repaid if the bank is wound up, is increasingly likely to be viewed as a form of lower-quality capital for banks.

A Moving Target: Debate about what constitutes core capital for banks is evolving and Fitch's definition of FCC may evolve, depending on regulatory discussions and analytical thought.

Limitations: The calculation of FCC and FEC represent quantitative measures of a bank's capitalisation. Fitch also considers other, more qualitative judgements (for example, the adequacy of loan impairment reserves or asset valuations), which may lead the agency to conclude that the bank's capitalisation is better or worse than that of peers despite the "first-cut" FCC/risk weighted assets ratio indicating otherwise.

Accounting Equity Used as Starting Point

Deriving core capital is an imprecise science, as the best starting point available is the accounting equity figure. Accounting equity has the following limitations as a basis for deriving a capital buffer for credit analysis:

- The intended purpose of accounting equity is not to present a buffer for absorbing losses in a stressed scenario. Rather, it shows what remains of a company's assets at a given date after its liabilities are deducted.
- Different accounting regimes have different requirements for whether an asset or liability is recognised (included on the balance sheet) and, if so, how these are valued.
- Even within the same accounting regimes – such as IFRS or US GAAP – there are a number of choices, especially regarding financial assets, about how assets and liabilities can be valued.
- Unless an asset is highly fungible and regularly traded, it is likely that different owners will identify different values for it, measured at fair value or as impaired or amortised.

Fitch's analysts recognise these limitations and consider different valuation and recognition approaches when carrying out peer analysis. Although the FCC definition does not attempt the impossible task of reconciling the various accounting alternatives, it does adjust accounting equity for assets that are not fungible and so would have little to no value in a stress scenario. In this respect Fitch's approach is similar to bank regulatory capital, including Basel III guidelines, the EU Capital Requirements Directive (CRD IV) proposals and US regulations.

Capital in Bank Credit Analysis

Credit analysts and debt investors expect capital allocated to equity holders to be available as a cushion to absorb unexpected losses in a stress scenario. This will often ensure that the bank can continue as a going concern, thereby staving off insolvency, or, if insolvency does become inevitable, to some degree absorb losses that would otherwise have to be borne by senior creditors and depositors.

The vast majority of banks rated by Fitch report under IFRS, US GAAP or local standards that are close to these. However, adjustments to equity reported in financial statements to derive regulatory Tier 1 ratios ("regulatory filters") vary considerably among jurisdictions. Some European regulators still use local GAAP rather than IFRS equity as a basis for their capital measures, while public financial reporting is in IFRS. The agency's key objectives in defining FCC are to establish:

- a globally consistent definition of what it considers to be the highest quality of capital, regardless of local regulatory adjustments in financial reporting, in order to facilitate analytical comparisons across banks and jurisdictions;
- emphasis on economic substance over accounting form where possible; and
- going-concern capital that provides financial flexibility to ensure viability of the bank, allowing it to continue operating during periods of financial stress

Determining Fitch Core Capital

FCC is derived from published financial statements and information in any published regulatory statements and disclosures. Fitch starts with reported equity, including all accumulated other comprehensive income (OCI) items, such as revaluation reserves on available-for-sale (AFS) securities and foreign exchange and including non-controlling interests (also known as "minority interests").

It makes adjustments from this number to eliminate first any hybrid capital, which is looked at separately (see relevant Related Research listed on page 1) and to deduct intangible assets

Related Criteria

Global Financial Institutions Rating Criteria (August 2011)

Treatment of Hybrids in Bank Capital Analysis (July 2011)

and certain other assets that Fitch does not consider to be reliably available to absorb losses. For the same reason, Fitch also adjusts equity for any accumulated gains/losses deriving from movements in the bank's own credit spread (in relation to any liabilities held at fair value).

The Decision to Adjust or Not Adjust for Certain Items in FCC

Fitch expects FCC to serve as a buffer to absorb unexpected losses. The agency adjusts reported equity for items with the following characteristics:

- They are not fungible and so would have little to no value in absorbing losses in a stress scenario.
- They are relatively easy to identify – if a decision of whether or not to adjust is finely balanced, the simpler solution is adopted over the more complex one.
- Where the question of whether or not to adjust is finely balanced, the more conservative approach is taken.

The table below provides a summary of adjustments made by Fitch to reported equity to derive FCC. Detailed discussion underlying the rationale for the adjustments is included in the report. The report also discusses other items that the agency does not make specific adjustment for in FCC but to which analysts give special consideration when assessing capital if the amounts involved are significant.

Appendix 1 provides a comparison of which highest-quality capital instruments are reported by banks under IFRS, various regulatory requirements and FCC.

Adjustments to Reported Equity Applied by Fitch to Derive FCC

Item Adjusted	Rationale
(-) Hybrid capital reported as equity	During the ongoing financial crisis, many hybrid capital instruments issued by banks failed to perform as loss-absorbing going-concern capital instruments.
(+) Non-controlling interests (also known as "minority interests") if reported outside published equity	Fitch bases its analysis on a bank's consolidated financial statements, which include the assets and liabilities of its subsidiaries. It is fair, therefore, to include the commensurate net asset value of the subsidiaries.
(-) Non-controlling interests not regarded by Fitch as loss-absorbing	Fitch only deducts non-controlling interests that it considers to be non loss-absorbing.
(-) Deferred tax assets (DTA) relating to losses carried forward that rely on future profitability to be realised	Fitch only deducts DTAs if they relate to losses carried forward. These DTAs are dependent on the bank making future profits and cannot be viewed as available to absorb losses up-front in stressed conditions.
(-) Goodwill and other intangibles	Such assets are difficult to monetise and will often be of low value when a bank is under stress.
(+/-) Fair-value adjustments relating to own credit risk on debt issued	Unrealised gains deriving from debt obligations are not available to absorb losses as debts must be repaid in full. Neither are unrealised losses arising from debt valuation adjustments a reflection of the debt the bank actually needs to repay.
(-) Equity interests in affiliated insurance businesses	Insurance risks and capitalisation, where material, are subject to separate analysis by Fitch alongside the analysis of risk in the banking business.
(-) First-loss tranche retained in off-balance-sheet exposures	These tranches are the first exposed to the risks affecting all the assets that were securitised. Fitch believes these assets generally have little value and would not be readily available to absorb losses.
(+) Fund for general banking risks if not already included and readily convertible into equity	Under IFRS and US GAAP, this fund is reported as part of the bank's equity. In some jurisdictions, local GAAP excludes this and Fitch analysts add it back in order to calculate FCC.

Source: Fitch

Fitch Adjustments to Reported Equity to Derive FCC

Hybrid Capital Reported as Equity

Some hybrid capital, such as most preference shares, is reported as equity, while other hybrid capital is reported as debt. The rationale for the accounting treatment can be complex and varies among accounting regimes. For IFRS, it largely reflects whether the security includes a promise to repay a substantial amount of the value back to the investor, in which case it is accounted for as debt. Under IFRS some trust preferred securities are included in equity as non-controlling interests.

Fitch Approach

Fitch subtracts all hybrid capital reported in equity for the purpose of arriving at its FCC measure. (Certain high-quality hybrid capital instruments may receive "equity credit" and can be included in the calculation of FEC, as described in the relevant criteria report; see under *Related Criteria* on page 2.)

Rationale: During the ongoing global financial crisis many hybrid securities issued by banks have failed to perform as loss-absorbing going-concern capital instruments (see *Bank Hybrid Securities; Debt Genes to the Fore During Financial Crisis* under *Related Research*). This led Fitch to review its equity credit criteria. It concluded that hybrids should not be regarded as representing part of the pool of highest-quality going-concern capital instruments available to banks. As a result, no hybrid instruments are included in FCC.

Non-Controlling Interests (Also Known as "Minority Interests")

Non-controlling interests are the net book value of third-party shareholdings in consolidated subsidiaries within a group. Under IFRS and, since the beginning of 2009, US GAAP, non-controlling interests are included in reported equity.

Fitch Approach

Fitch only subtracts non-controlling interests from FCC to the extent that it considers these to be non-loss-absorbing. This may, for example, be the case where the accounting consolidates securitisation vehicles or private equity investments because the bank is deemed to have a controlling interest (by virtue of nobody else having more of an interest). Some trust-preferred securities are included as non-controlling interests in published financial statements and Fitch deducts these along with other hybrid capital from FCC.

Rationale: Fitch bases its analysis on banks' consolidated financial statements, which include the assets and liabilities of the subsidiaries. It seems fair, therefore, to include the commensurate net asset value. In most cases, Fitch will include non-controlling interests as part of FCC on the basis that these represent share capital within the group that Fitch considers is available to absorb losses. This is also the agency's default position when information is not available to distinguish between various groups of non-controlling interests, although Fitch does endeavour to obtain information beyond what is published for rated banks with material and complex non-controlling interests. Understanding the group structure of a rated financial institution (FI) is fundamental in determining which non-controlling interests may, or may not, represent a source of stable, loss-absorbing capital.

In some circumstances, Fitch may subtract non-controlling interests from FCC if it believes that strong legal protection laws for non-controlling interests would prevent the capital from being available to the group. This may be the case, for example, where Fitch analysts consider that regulators may seek to trap capital in one jurisdiction and prevent it from being upstreamed to the parent. In general, Fitch believes that capital is more likely to be fungible between entities where management control of the group is centralised, but this is not always the case.

Fitch considers that capital resources are not available solely to absorb losses in the subsidiaries to which they relate – capital resources can be fungible within a banking group –

assets may be transferred, funding passed around, dividend policies altered and other mechanisms applied. Disclosure regarding non-controlling interests tends to be poor. Better disclosure, showing to which subsidiaries the most material non-controlling interests relate, would enable credit analysts and regulators to make more informed choices about including or excluding these from core capital calculations.

Deferred Tax Assets and Deferred Tax Liabilities

Deferred tax represents the difference between current tax charges or credits recognised by the tax authorities in the respective regimes in which a bank operates and total taxes recorded in financial statements. Under both IFRS and US GAAP, the tax charges/credits in financial statements reflect changes in value of all assets and liabilities. The timing of recognising changes in value in the accounts may differ from when gains and losses are recognised by the tax authorities, particularly when these are unrealised.

Deferred tax assets (DTAs) represent the debit side of accounting for deferred tax credits (reducing accounting tax and therefore increasing net income and equity) taken through the income statement or direct to equity through OCI. The deferred tax credit goes through the income statement if the expense/loss it relates to goes through the income statement. For losses direct to equity – eg on AFS securities or pension liabilities – the deferred tax credit will go directly to equity.

DTAs can relate to annual losses carried forward to offset against future taxable annual net income of the reporting company or its subsidiaries to reduce the tax charge. (In US GAAP these are called net operating losses or NOLs.) This expected future reduction in the tax charge is accounted for in the income statement as deferred tax and reduces the accounting net tax charge in the year, with the other side of the accounting booked as a DTA.

Deferred tax liabilities (DTLs) are the mirror image of DTAs. They represent the liability recorded on the balance sheet for deferred tax charges. DTLs increase the accounting tax and therefore reduce net income and equity. The deferred tax charge goes through the income statement if the related revenue/gains go through the income statement. For gains direct to equity – eg, on AFS securities – the deferred tax charge will go directly to equity.

Fitch Approach

Fitch subtracts DTAs in full from reported equity to calculate FCC if these relate to losses carried forward (or NOLs) and rely on future profitability of the bank to be realised.

If the analyst thinks that the bank can produce profits to offset losses in the short term, and thereby unlock tangible value in the DTAs, this will be considered by Fitch analysts in their broader rating analysis.

Generally, Fitch makes no adjustment for other DTAs or DTLs. If a bank fails to disclose sufficient information to determine the amount of DTAs that relate to losses carried forward rather than other (usually unrealised) losses, Fitch deducts all DTAs net of DTLs (allowing a minimum result of zero) from reported equity to calculate FCC. Disclosure is most likely to be sparse when DTAs are small relative to other assets. FI disclosure about DTAs is often poor in interim financial statements, and in these cases Fitch takes DTAs relating to losses carried forward from the annual statements as a proxy.

Rationale: Deferred tax usually relates only to timing differences between financial reporting and tax recognition of specific assets or liabilities, and this often relates to unrealised gains and losses that may not crystallise in a stress scenario. Once these losses are realised, the tax asset will become real rather than deferred. Therefore, most DTAs and DTLs become real tax liabilities or credits, capable of increasing/reducing tax payments in future periods, even if those periods are stressed. For this reason, Fitch only adjusts for DTAs relating to losses carried forward. These DTAs are dependent on the bank or its subsidiaries making future annual

profits, and so cannot be considered as available to absorb losses up front in stressed conditions.

Goodwill and Other Intangibles

Goodwill, at least in theory, represents additional value paid for a business above and beyond the net fair values of each of its individually identifiable assets and liabilities. Because goodwill is no longer amortised in IFRS or in US GAAP, it remains on the balance sheet at cost even as businesses it relates to create the additional projected wealth at the time of acquisition and enhance the bank's consolidated equity. Goodwill must be impaired only if the net present value of cash flows in the business unit it sits in falls below book value.

It is possible, but rare, to generate an intangible asset internally. Intangible assets in banks' financial statements arise almost exclusively from business acquisitions or purchases of assets. These can include brand names or customer lists. US mortgage-originating FIs that remain servicers of assets (the mortgages) transferred have intangible assets called mortgage-servicing rights (MSRs) on their balance sheets, essentially representing expected future cash flows from servicing the mortgage loans, with the key valuation determinant being interest-rate projections.

Fitch Approach

Fitch subtracts any goodwill and all other intangible assets from reported equity to derive FCC. Where analysts consider certain intangibles to be fungible assets reported consistently at market value, such as some MSRs, this will be taken into account in their broader rating analysis.

Disclosure relating to MSRs sometimes includes specific mention of related MSR DTLs on the balance sheets of US mortgage-originating FIs, reflecting future tax payments due on the expected future cash flows from servicing the mortgage loans. In these cases Fitch will deduct the net amount of MSRs from FCC.

Rationale: Goodwill and other intangible assets are difficult to monetise and will often be of low value when a FI is under stress.

Fair-Value Movements Relating to Own Credit Risk on Debt Issued

A bank has the option of reporting its own debt issued at fair value, with mark-to-market impacts being taken through the income statement. Hedged debt issued with a fixed interest coupon may also be reported at fair value, either in full or in part, as a result of hedge accounting. The value of the debt will move in line with its market value. Generally, when the credit spreads of the bank in question widen, the debt value reduces, resulting in unrealised gains being booked through the income statement, which leads to a higher reported equity figure. Correspondingly, when credit spreads tighten, debt values go up and unrealised losses are booked through the income statement, resulting in lower reported equity.

Credit spreads have a similar impact on the fair value of derivatives in a liability position. Derivatives are reported at fair value and this includes a credit component for the counterparty that is "out of the money", which will reduce the derivatives liability reported on the balance sheet when the bank's credit spread deteriorates, and increase the liability when it improves. The amounts relating to own credit risk on derivatives are small at most banks and are not consistently disclosed, although US GAAP does require disclosure for US banks. Fitch does not adjust for the credit component of a bank's derivatives in its standard calculations of FCC, but where derivatives are a substantial part of the balance sheet analysts consider the impact of the own credit spread component in their broader analysis of capital.

Fitch Approach

Fitch deducts fair-value movements relating to own credit risk on debt instruments from equity to calculate FCC. Where this item is not disclosed in financial statements, regulatory (eg: Basel

II Pillar 3) or other disclosures, Fitch adjusts for the entire fair-value component of a bank's own liabilities (the difference between the nominal amount to be repaid and the fair value) excluding derivatives. The agency deducts the credit component or entire fair-value component from accounting equity in the case of a cumulative gain or adds it back in the case of a loss. If the adjustment is a large amount, Fitch analysts also adjust for related DTLs or DTAs where possible.

Again, where information is available for the year-end but not for interim period ends, analysts will use the year-end number as a proxy and may adjust this for the movement in the period if this is available. There are no current disclosure requirements in IFRS for the own credit spread on derivatives liabilities and such disclosure is rarely provided by FIs outside the US.

Rationale: Credit analysis looks to full repayment of debt and other liabilities due rather than debt at fair value. Unrealised gains deriving from debt obligations are not available to absorb losses arising elsewhere in the business. Similarly, a loss incurred on a valuation basis as the value of debt rises is no reflection of the debt a bank actually needs to repay. Most debt reported at fair value is hedging or being hedged by an asset or liability showing matching but opposite movements in fair value, and it would be wrong to adjust for only one side of these transactions. This is why, to the extent disclosure allows, Fitch adjusts only for the own credit component of the fair-value movement.

If the bank repurchases debt in the market at a low value and realises a gain, its obligations have been genuinely reduced, and Fitch makes no deductions to equity for the purpose of calculating FCC.

Equity Interests in Affiliated Insurance Businesses

A bank's interest in an insurance business in its consolidated accounts will be represented by the net asset value of the business. If embedded value (future projected cash flows from life assurance premiums net of projected outflows) is reported as an asset on balance sheet, this relates to life assurance operations first and foremost and would not be available to absorb losses in banking operations.

Fitch Approach

Fitch subtracts equity in affiliated insurance companies from equity in order to derive FCC. Again, these investments may not be readily disclosed in the financial statements, although they are often deducted from regulatory capital and the amount to deduct can, therefore, usually be found in the relevant regulatory disclosure. Bank regulators generally exclude assets in consolidated insurance companies from risk-weighted assets. Where this is not the case, the FCC/risk weighted assets ratio will be understated and analysts make allowance for this, where significant, in their broader analysis.

Rationale: Fitch analyses the risks a bank is exposed to in its insurance business independently. Once analyses of both the insurance and the banking businesses are complete, the agency factors into the ratings of the consolidated group any credit for surplus capital in the insurance operation commensurate with the rating level being considered.

First-Loss Tranches Retained in Off-Balance-Sheet Securitised Exposures

Fitch Approach

First-loss tranches are often retained by banks when they securitise assets. These tranches are first exposed to the risks affecting all the assets that were securitised. If the bank is able to derecognise the securitised assets (remove them from its balance sheet), Fitch deducts the first-loss tranche from equity to derive FCC.

Rationale: In its analysis, Fitch gives special consideration to securitised assets whether or not they are reported on balance sheet, and evaluates the degree to which these have been included in risk-weighted assets by the regulator. When securitised assets are not included on

balance sheet or in risk-weighted assets, the first-loss tranche of a securitisation held by the bank is deducted from equity to calculate FCC. This reflects Fitch's view that these assets generally have little to no value, and so would not be available to absorb losses.

Items Not Adjusted by Fitch to Derive FCC

Unrealised Trading Securities Gains and Losses

Unrealised trading gains and losses relate to trading book assets, with income booked through the profit and loss account, which subsequently flows through to equity. Fitch makes no adjustment for this item in its calculation of FCC. To the extent that unrealised gains and losses are not subtracted from FCC, this results in the FCC number being higher when there are gains and lower when there are losses. For simplicity, Fitch includes in this category all gains and losses on derivatives and on assets the bank has opted to report as fair value through the income statement.

Rationale: Trading book assets are held primarily with the aim of selling them in the short term, so there is a strong logic for not adjusting for unrealised trading gains and losses, as this would introduce an unreasonable aspect of volatility into the capital figure. If one did take the view that these unrealised gains and losses should be adjusted, there would be practical difficulties in identifying the information needed to make these adjustments.

Unrealised Gains and Losses on AFS Securities

Unrealised gains and losses on AFS securities are reported in equity under IFRS and US GAAP (net of tax), and Fitch includes these in FCC, making no adjustments. FCC is higher when there are unrealised gains and lower when there are unrealised losses. Under US GAAP unrealised non-credit losses on held-to-maturity (HTM) securities are also reported in equity. Fitch makes no adjustment for these either.

Rationale: Fitch considers there to be a convincing rationale both for including and for excluding these items from FCC. The rationale for not adjusting is broadly the same as that for trading securities gains and losses above. However, many industry participants argue that, particularly with debt securities, the current fair value of these assets does not represent a value to the bank's business because there is no intention to sell in the short term, and, unless assets are impaired, fair-value losses will not be realised because debt will be fully repaid at maturity. Some regulators exclude accumulated fair-value gains or losses on AFS debt securities from regulatory capital. Adopting this approach would present practical difficulties to Fitch because it is unusual for banks to disclose the fair-value impact from AFS debt securities separately from unrealised gains/losses on equity securities.

A conservative approach, and arguably an appropriate one for a credit rating agency, would be to recognise fair-value losses but deduct fair-value gains in the FCC calculation. However, because these fair-value gains and losses are usually reported (at least in the public domain) net of each other and not gross there is again a disclosure problem. If banks were required to report all fair-value gains gross, Fitch might alter its consideration of these and deduct them from equity to derive FCC.

The securities are also sometimes hedged with derivatives, whose fair-value gains and losses are not adjusted.

For the time being, Fitch has decided that it is more straightforward to follow the accounting treatment for AFS securities in its FCC calculations, which is net of deferred tax. Where these positions are large, as is often the case, analysts consider the impact they have on capital in their broader rating analysis.

Foreign Exchange Reserves Gains/Losses

Fitch does not adjust for movements in foreign-exchange reserves of the parent bank, which usually arise from investments in foreign subsidiaries. Equity increases when the parent bank's currency has depreciated against the subsidiary's currency (the value of the foreign-exchange investment in the reporting currency has risen) and decreases when the parent bank's currency has appreciated.

Rationale: Debt obligations are reported in the currency applicable to the parent bank. The degree to which net investments in foreign subsidiaries are available to pay these is best measured by considering their value in this currency. Adjusting for this item would contradict that.

Unrealised Gains and Losses on Land and Buildings

Land and buildings can be accounted for at fair value under IFRS and in some local GAAP regimes, but not under US GAAP. Fitch does not adjust for fair values of fixed assets or investment properties.

Rationale: The agency recognises that mark-to-market gains on real estate, as on securities, can be difficult to realise in times of stress, when the commercial property market tends to lose liquidity. However, Fitch's inclusion of these fair values in FCC is consistent with its treatment of fair-valued securities. The agency also considers that it would be unreasonable to make a deduction to FCC for fair value on a building purchased 20 years ago, when no deduction would be made for an identical building at the same value purchased recently.

Unrealised Gains and Losses on Tangible Fixed Assets Other Than Land and Buildings

In deriving FCC Fitch does not subtract for unrealised gains and losses on fixed assets other than land and buildings. In general, these amounts are not material in relation to a bank's overall balance sheet. Where these amounts are significant, analysts consider whether they are available to absorb losses and, if not, take this into account in their bank-specific assessment of whether capitalisation is adequate.

Cash Flow Hedge Reserve

This item within reported equity is a "parking place" in the financial statements for movements on derivatives that are recognised for accounting purposes as cash flow hedges. This means that they relate to specifically identified future cash flows and will amortise into the income statement as these cash flows arise. This peculiar accounting treatment is necessary to avoid taking fair-value changes on the derivatives to the income statement in different periods to the cash flows they are hedging.

The fair value of the derivatives in question are reported under assets or liabilities along with other derivatives, but rather than movements in fair value reported through the income statement (as is otherwise the case for derivatives), these are booked directly to equity in the cash flow hedge reserve. They can relate to cash flows on a variety of assets (often floating-rate securities) or forecast cash flows on transactions.

Rationale: Fitch makes no adjustment to FCC for cash flow hedges, largely to avoid the complexity of trying to adjust for some items and not for others when disclosure is rarely available.

Pension Reserves

Pension reserves represent the net present value of expected amounts the bank will have to pay out in relation to its pension obligations less the fair value of any assets in which the bank has invested (usually through pension funds) for the purpose of paying future pensions. Some adjustments to the estimate of net pension obligations are taken directly to equity, and some regulators adjust regulatory capital to add back an element of the accounting pension obligation to reflect actual expected payments over the coming years.

In some cases, pension obligations net of invested assets are in surplus, so that a pension asset is shown on the balance sheet and included in equity. Under the corridor method, allowed in IFRS until recently, certain pension liabilities, which can be large amounts, remain off balance sheet and are not reflected in equity (so equity is overstated). The International Accounting Standards Board (IASB) eliminated the option to use the corridor method from its pensions accounting standard in June 2011, effective 2013 at the latest.

Rationale: Trying to make adjustments for pension obligations would be challenging in light of the varying accounting treatments and requirements by pension regulators. Elimination of the corridor method will reduce reported equity for some companies, but in the interests of simplicity Fitch does not make any adjustments for pensions in its FCC calculation. Where pension liabilities are large, Fitch will consider them in its broader analysis of capital.

Stock Options to be Settled as Equity

Granting of stock options results in an income statement expense for the value of stock options (reducing equity) and a corresponding increase directly to equity, representing a future increase in equity when options are exercised. In practice, a bank either buys back its own shares (in cash) or issues equity in anticipation of paying for shares when the options vest. In both cases, real share capital is increased at the time options vest (ie, treasury shares are released back into the market). Fitch makes no adjustment for these in its FCC calculation.

Rationale: Fitch does not consider the increase in equity as loss-absorbing in that it relates to expectations of future share capital once the options are exercised; the agency similarly does not consider the expensing of these options as a reduction of loss-absorbing capital. As these two items more or less net off in reported equity, no adjustment is made.

Large Equity Investments in Non-Bank Companies

Where banks have large, sometimes controlling, investments in non-bank companies other than insurance companies, no adjustment is made by Fitch. Regulators usually deduct large investments in non-bank companies from regulatory capital.

Rationale: Where these companies are consolidated, it is usually difficult to isolate the assets and liabilities that relate to them. Where they are not consolidated, they are usually included among equity investments or accounted for at equity as associates. In either case, disclosure does not generally and certainly does not consistently enable analysts to isolate the amounts relating to these investments from other equity investments, so adjustments would be difficult to make in practice. Where such holdings are material, Fitch analysts carry out separate analysis and consider the impact they have on the bank's capitalisation in their broader rating analysis.

Unaccrued Dividends

Under IFRS and US GAAP dividend payments are booked when they are declared. This contrasts with UK and some other GAAPs where dividend liabilities are recorded as they relate to the accounting period (ie, often declared after the year-end). For credit analysts, determining the level of earnings for a period that pass into loss-absorbing capital, the UK GAAP treatment is more relevant. However, Fitch does not adjust for this in its FCC calculation.

Rationale: Again simplicity prevails. The dividend is usually not large in relation to total FCC, and usually this number is available only a few months after year end.

Differences Between Expected Loss (EL) and Accounting Impairment

EL is a statistical concept that banks using Basel II's internal ratings-based approaches (IRB) have to apply. Basel II requires banks to compute EL for the following year, compare this with their financial accounting impairment provisions and, when the EL amount is greater, provide for the difference by deducting the amount from regulatory capital (many regulators allow 50% deduction from Tier 1 and 50% from Tier 2 capital). Conversely, when EL is less than the financial accounting amount, some regulators allow the difference to be recognised in Tier 2

capital (under Basel II, reiterated in Basel III, specification up to a maximum of 0.6% of credit risk-weighted assets under IRB; Basel III clarifies that national regulators may apply a limit lower than 0.6%).

Rationale: Fitch makes no adjustment for EL versus financial accounting impairment, as the adequacy of a bank's provisioning is something that is considered separately from capital as part of the agency's analysis of the bank's asset quality. Furthermore, the adjustments made by regulators only apply to banks using the IRB approach, and even then adjustments will vary among regulators. The IASB is developing a proposal to move from "incurred" to "expected" losses for credit impairment of bank financial assets. Fitch would support this move as it would provide more meaningful accounting for credit analysis.

Appendix 1: Capital Adjustments Comparison

Figure 1

IFRS, Regulatory, Fitch Comparison: Highest-Quality Capital

	IFRS equity	Basel Tier 1 current[a]	Common capital Tier 1 (US)	US GAAP	Fitch core capital	Basel III[f] common equity Tier 1	CRD IV[g] proposals common equity Tier 1
Credit spread on fair value of own debt[b]	In	Out	Out	In	Out	Out	Out
Fair-value (FV) changes on loans classified as AFS[c]	In	Out	Out	In	In	In	In
FV changes on equities in AFS[c]	In	Gains out losses in	In	In	In	In	In
FV changes on debt classified as AFS[c]	In	Gains out, losses out/in	Out	In	In	In	In
Cash flow hedge item	In	Some out[c]	Out	In	In	Out	Out
FV change on land and buildings	In	Gains out, losses in	n.a.	Out	In	In	In
Investments in insurance companies	In	Out	In	In	Out	Out	Out but may continue to deduct according to existing Directives that allow greater flexibility
Expected loss adjustment	Out	In	Out	Out	Out	In	In
Deferred tax assets on losses carried forward	In	In	Some out[d]	In	Out	Out	Out
Large investments in non-FIs	In	Some out[e]	In	In	In	1,250% risk weight	Either out or 1,250% risk weight

[a] Basel committee "recommends", does not mandate
[b] All are net of (deferred) tax
[c] Follows asset/liability being hedged. If hedged asset/liability is adjusted in Tier 1 capital, so is the cash flow hedge that is hedging it.
[d] DTAs limited to the lesser of: amount expect to realise within one year; and 10% of Tier 1 capital.
[e] Portion exceeding 15% of the bank's capital for individual investments and 60% capital in aggregate, deducted 50/50 from Tier 1/Tier 2.
[f] Basel III: A global regulatory framework for more resilient banks and banking systems, published in December 2010.
[g] The European Commission published *Proposals regarding regulations for prudential requirements for credit institutions and investment firms* on 20 July 2011; these are collectively known as CRDIV.
Source: Basel III: A regulatory framework for more resilient banks and banking systems, December 2010, revised June 2011; European Commission Proposal for a regulation of the European Parliament and of the council on prudential requirements for credit institutions and investment firms, 20 July 2011; Guidelines established by US Regulators for Tier 1 Common Capital.

Global
Sector-Specific Criteria
Report

Treatment of Hybrids in Bank Capital Analysis

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Related Research

Applicable Criteria

- *Global Financial Institutions Rating Criteria (August 2010)*
- *Short-Term Ratings Criteria for Corporate Finance (November 2010)*
- *Rating Hybrid Securities (December 2009)*

Other Research

- *Fitch Clarifies That It Expects to Be Able to Rate New Generation Bank Hybrid Securities (November 2010)*
- *Bank Hybrid Securities - Debt Genes to the Fore During Financial Crisis (February 2011)*
- *Fitch to Review Equity Credit for Hybrid & Capital Securities (September 2010)*
- *Core Capital in Financial Institutions: The Fitch Perspective (March 2010)*

Summary

This criteria report covers how Fitch Ratings will treat hybrid securities (or assign "equity credit") in its analysis of bank and bank holding company capital. It also covers the criteria under which equity credit will be assigned to hybrid securities issued by most non-bank financial institutions, such as securities firms, leasing companies and non-bank lenders. Where Fitch determines that hybrid treatment for a non-bank financial institution would be more appropriately assessed under different criteria (eg, corporate criteria), this will be clearly identified in the agency's research. Asset managers are likely to be an example of this.

Separate criteria reports are being published for the insurance sector, and for the corporate and real estate investment trust (REIT) sectors. This criteria report does not address how hybrid securities, including contingent convertible securities (CoCos), are rated.

Highlights of this report include:

Simplification of categories. The number of equity credit categories has been reduced to three (100%, 50% and zero) from five. This is designed to avoid a false degree of precision and to recognise that in some cases, the additional complexity associated with such features has negatively affected hybrids' performance.

Fitch core capital (FCC), which is based on common equity and reserves less certain deductions, becomes the primary measure of bank capitalisation. This reflects Fitch's belief that common equity is the most effective form of capital for maintaining a bank's viability, given its high loss absorption potential as "first loss" capital, full dividend flexibility as well as its contribution to maintaining (or at least not harming) bank confidence.

Nonetheless, Fitch still sees merit in quantitatively measuring the existence of good-quality hybrid capital in an ancillary ratio. Consequently, Fitch will continue to calculate Fitch eligible capital (FEC) for banks, complementing regulatory capital and other market measures of bank capitalisation. Fitch's FEC adjusts FCC to the extent that a bank's hybrid securities receive "equity credit".

More stringent requirements for hybrid securities to receive equity credit. Only certain subordinated mandatory convertible securities will be able to achieve 100% equity credit, as will permanent, subordinated securities with unrestricted coupon omission features that have the ability to be written down or converted to equity well before a bank becomes non-viable.

Subordinated instruments with no impediment to coupon omission and certain other mandatory convertible securities will be able to achieve 50% equity credit. In addition, subordinated instruments which are not deferrable but which would be expected to convert to equity well before financial stress will also be able to achieve 50% equity credit.

No cap on amount of hybrids that receive equity credit in FEC. As FCC has become Fitch's principal measure of bank capitalisation, the agency will not restrict the amount of hybrid securities that receive equity credit in its calculation of FEC.

Scope

This criteria report is directed towards the evaluation of hybrid instruments invested in by unaffiliated investors who are expected to exercise all remedies available to them. Government subscribers to hybrid securities may not always fit this description, while companies making a capital injection into a subsidiary frequently use hybrid structures to increase the tax efficiency of their investment.

In such cases, Fitch rating committees may apply different standards and assign equity credit to a security where it would not have been achievable in the hands of an unaffiliated investor.

Process Considerations

These criteria on hybrid treatment apply to outstanding hybrid securities as well as to hybrids issued after this report's publication.

Bank hybrid capital is a rapidly evolving asset class. As a result, Fitch's equity credit criteria may be liable to more frequent revision than other criteria. In any case, they will be updated at least annually. Rating committees retain flexibility in application of these criteria to specific situations not contemplated in this report.

What is Equity Credit?

Equity credit is an analytical concept that expresses the extent to which Fitch views a security as containing debt-like or equity-like qualities in a risk-adjusted evaluation of an issuer's capital structure and financial leverage. Such risk-adjusted evaluations of capital are used in support of the Individual Rating[1] that Fitch assigns to the issuer itself. The Individual Rating is a measure of the likelihood that an issuer may fail and either default on its obligations or need external support in order to avoid default. Where a bank's Long- and Short-Term Issuer Default Ratings (IDRs) are based on its Individual Rating, rather than its Support Rating, equity credit may also affect the level of a bank's IDRs.

Capital securities and hybrids are evaluated as to their likely effect on the viability of the issuer and on the issuer's senior obligations under the condition of financial stress, regardless of the probability that such financial distress will occur.

Fitch's allocation of part or all of a hybrid instrument to equity is not driven by accounting rules. Financial reporting standards do not determine the agency's analytical assessment, although changes in accounting standards may cause Fitch to alter its adjustments to data derived from financial statements.

High-Level Principles

Nothing Beats Common Equity

- Common stock and reserves are invariably more supportive of bank viability than any hybrid security
- FCC becomes Fitch's primary measure of bank capitalisation

The experience of the financial crisis has strongly re-emphasised that hybrids are only effective to the extent that they contribute to the ongoing viability of an organisation, and this is the overarching principle Fitch has employed when determining the extent to which a hybrid security can achieve equity credit. In essence, bank hybrids have the potential to support the issuer's viability if they are able to cancel coupons and/or be written off or converted to common equity (or equivalent "first loss" capital). This does not automatically mean all securities with such features will receive equity credit, however.

For banks, the recent financial crisis demonstrated the importance of maintaining confidence and rapid loss absorption in preserving the viability of a banking organisation. Common equity is viewed as the most effective form of capital for maintaining a bank's viability given its high loss absorption potential as "first loss"

[1] Individual Ratings are likely to be replaced by Viability Ratings in 2011. See Fitch's report "*Perspectives on Bank Credit Ratings in a Changing Environment*" (7 March 2011)

capital, full dividend flexibility as well as its contribution to maintaining (or at least not harming) confidence. Although hybrids aim to replicate some of the key features of common equity, Fitch views them as invariably being less versatile than common stock.

While the ultimate features of "new generation" bank hybrid securities will no doubt vary globally by jurisdiction, Fitch believes that new-generation hybrids that are in line with Basel 3 "additional Tier 1" capital will provide greater equity-like benefits for banks than old-generation hybrid securities (see *"Bank Hybrid Securities: Debt Genes To The Fore During Financial Crisis"*, published on 10 February 2011). This is not simply because the issuer must have full discretion to cancel a coupon, but also because of the clearly defined role that these instruments are expected to play within the new "capital conservation buffer" zone framework being phased in from January 2016 and the requirement that they be written down or converted into "first loss" capital on a trigger event.

Although it is unclear at exactly what point a bank will be required by its regulator to cancel a coupon, this is likely to happen as the bank is entering its capital conservation buffer zone, where it is captured by the Basel definition of "Elements subject to the restriction on distributions" (Basel Para 132 (a)): "Items considered to be distributions include dividends and share buybacks, **discretionary payments on other Tier 1 capital instruments** and discretionary bonus payments to staff."

The superiority of common equity means FCC, largely consisting of common equity and reserves, will now be Fitch's primary measure of capitalisation when assessing a bank's Individual Rating in most circumstances (see *"Core Capital in Financial Institutions: The Fitch Perspective"*, published on 1 March 2010).

Where hybrid securities are expected to contribute to the preservation of viability and therefore receive equity credit, this will continue to be captured in the FEC ratio. Such instruments should generally enhance "first loss" capital well before financial stress. The FEC ratio will remain an important measure of bank capitalisation in Fitch's analysis as it will represent a quantitative measure of secondary-quality capital and will differentiate banks with this form of going concern "insurance" from those without it (or those with more of it from those with less of it).

No Cap on Amount of Hybrids That Receive Equity Credit in FEC

Because FCC has become Fitch's principal measure of bank capitalisation, Fitch will not restrict the amount of hybrid securities that receive equity credit in its calculation of FEC.

- Equity credit buckets restricted to 100%, 50% and 0%

Equity Credit Buckets Limited to 100%, 50% and 0%

Consistent with other Fitch groups, the Financial Institutions group has reduced its equity credit treatment of hybrids from five categories to three: 100%, 50% and 0%. This reflects Fitch's desire to avoid a false degree of precision. Fine nuances in hybrid design have often not materially affected an issuer's ability to maintain viability and in some cases, the additional complexity associated with such features has negatively affected performance.

- "High trigger" Tier 1 instruments and certain mandatory convertibles may be able to achieve full equity credit

100% Equity Credit

Perpetual Instruments With Coupon Omission Features

The following features will be necessary for such securities to achieve 100% equity credit:

Subordination: The securities must be subordinated to all senior creditors and in most cases senior only to common equity or, for non-joint stock companies, the most comparable "first loss" capital.

Permanence: The securities must be perpetual, with no step-ups or incentives to redeem. They must have at least five years to the first call date at issue, and supervisory approval is required for any repayment of principal.

Full discretion to cancel coupons: This means features such as look-back/dividend pusher clauses and parity securities language are likely to negate a security's ability to obtain equity credit.

Permanent and full write-down or conversion to "first loss" capital (in most instances common equity) well before a bank becomes non-viable: The point at which a bank might be considered non-viable will be determined by a rating committee and is likely to vary by type of bank and by jurisdiction. For example, a low-profile retail bank in a stable market may be able to operate very comfortably with a significantly lower common equity Tier 1 ratio than a high-profile universal bank with very public, high minimum capital requirements. As bank capital frameworks settle down, Fitch will endeavour to give more concrete guidance on this aspect.

Exchange price or ratio: An issuer must usually have authorisation/capacity to issue the required number of shares to complete any conversion. If Fitch has concerns that the exchange terms might create significant incentives to take actions (eg, repurchase the securities, asset sales) in order to avoid excessive dilution, equity credit may be reduced to 50% or even zero.

Figure 1

Hybrid Treatment as FEC[a] — Illustrative Summary

Hybrid type	Treatment in the FEC ratio
Perpetual instrument with coupon omission features	50% equity
Mandatorily convertible (true)	
- Subordinated, conversion within 3 yrs, full discretion to cancel coupons	100% equity
- Subordinated, conversion within 5 yrs, deferrable or full discretion to cancel coupons, does not meet requirements for 100%.	50% equity
- Senior or subordinated without coupon deferral; conversion within 1 yr	50% equity
Mandatorily convertible (synthetic)	
- Underlying debt	0% equity
- Forward contract	0% equity at issuance
	100% equity upon funding
Optionally convertible hybrid	As host instrument
Contingent convertibles (CoCos)	
- High trigger[b], no restrictions on coupon omission (eg, Basel 3 Tier 1 host instrument, high trigger)	100% equity
- High trigger[b], non-deferrable (eg, Basel 3 Tier 2 host instrument, high trigger)	50% equity
- Low trigger[b]	As host instrument

Notes: This is an illustrative summary only based on typical or anticipated hybrid features — see the criteria for further details. Hybrid or capital instruments not listed above would not typically be treated as equity as part of the FEC ratio

[a] FEC is an ancillary capital ratio. FCC is the agency's primary capitalisation measure and excludes all hybrid securities

[b] A "High trigger" for contingent conversion to equity (or principal writedown) implies a conversion or writedown well before a bank becomes non-viable. A "Low trigger" implies a writedown or conversion to equity that may be close to the point of non-viability.

Source: Fitch

Mandatorily Convertible Securities

The following approach will be used for securities with mandatory conversion features that do not hinge on a trigger event; rather, they mandatorily convert to "first loss" capital at a pre-determined date in the relatively near future. These are rare in the banking universe. In order to achieve 100% equity credit, all of the following features will be necessary:

Subordination: The securities must be subordinated to all senior creditors.

Full discretion to cancel coupons: See above.

Short period until conversion: The securities must convert to common equity or equivalent "first loss" capital within three years. Even then, a rating committee may elect not to assign equity credit if there are material concerns about the viability of the bank in the period before conversion. In such a case, equity credit will be capped at the level the security would achieve without the mandatory conversion feature.

Exchange price or ratio: An issuer must usually have authorisation/capacity to issue the required number of shares to complete any conversion. If Fitch has concerns that the exchange terms might create significant incentives to take actions (eg, repurchase the securities, asset sales) in order to avoid excessive dilution, equity credit may be reduced to 50% or even zero.

Synthetic units (mandatorily convertible securities with a timing difference between the maturity of a debt instrument and a forward purchase of equity or similar securities; for example, five-year debt combined with a three-year forward contract) will be treated as debt until the date equity is actually issued under the forward contract.

50% Equity Credit

Perpetual Instruments With Coupon Omission Features

The following features will be necessary to achieve 50% equity credit:

Subordination: The securities must be subordinated to all senior creditors and in most cases senior only to common equity or, for non-joint stock companies, the most comparable "first loss" capital.

Permanence: The securities must be perpetual, with no step-ups or other incentives to redeem. They must have at least five years to the first call date at issue, and supervisory approval is required for any repayment of principal.

Full discretion to cancel coupons: This means features such as look-back/dividend pusher clauses and parity securities language are likely to negate a security's ability to obtain equity credit.

While contingent write-down or equity conversion is not a requirement for such securities to achieve equity credit, it will be a requirement for Basel 3-compliant Tier 1 instruments from 2013.

Dated Instruments Without Coupon Omission Features

The following features will be necessary to achieve 50% equity credit:

Subordination: The securities must be subordinated to all senior creditors.

Maturity: The securities must have at least five years to maturity.

Permanent and full write-down or conversion to "first loss" capital (in most instances common equity) well before a bank becomes non-viable: Again, the point at which a bank might be considered non-viable will be determined by a rating committee and is likely to vary by type of bank and by jurisdiction.

Mandatorily Convertible Securities

The following features will be necessary to achieve 50% equity credit:

a) **Host instrument is a senior instrument or subordinated instrument without coupon deferral or omission features:**

Short period until conversion: The securities must convert to common equity or equivalent "first loss" capital within one year. Even then, a rating committee may elect not to assign equity credit if there are material concerns about viability of the bank in the period before conversion. In such a case, no equity credit will be assigned.

Exchange price or ratio: An issuer must usually have authorisation/capacity to issue the required number of shares to complete any conversion. If Fitch has concerns that the exchange terms might create significant incentives to take actions (eg, repurchase the securities, asset sales) in order to avoid excessive dilution, equity credit may be eliminated.

b) **Host instrument is a subordinated instrument with coupon deferral or omission features:**

Subordination: The securities must be subordinated to all senior creditors.

Full discretion to cancel or to defer coupons.

Short period until conversion: The securities must convert to common equity or equivalent "first loss" capital within five years and the requirements for 100% equity credit for mandatory convertibles are not met. Even then, a rating committee may elect not to assign equity credit if there are material concerns about the viability of the bank in the period before conversion.

Exchange price or ratio: An issuer must usually have authorisation/capacity to issue the required number of shares to complete any conversion. If Fitch has concerns that the exchange terms might create significant incentives to take actions (eg, repurchase the securities, asset sales) in order to avoid excessive dilution, equity credit may be eliminated.

Rating Bank Regulatory Capital and Similar Securities

Sector-Specific Rating Criteria

This criteria report and other sector specific reports replace *Rating Hybrid Securities*, dated 28 July 2011, which has been withdrawn. It also concludes a review of the way Fitch rates bank hybrid securities that was initiated by an exposure draft entitled *Rating Bank Regulatory Capital Securities*, dated 28 July 2011.

Related Research

Treatment and Notching of Hybrids in Corporates & REITs (December 2011)

Treatment of Hybrids in Bank Capital Analysis (July 2011)

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Scope: These criteria are used by Fitch Ratings for rating bank regulatory capital (subordinated and hybrid debt) and other securities that, in Fitch's view, share the same substance, irrespective of their regulatory treatment (together, "bank hybrid securities").

Hybrid Non-Performance Definition: Coupon omission or deferral, write-down or conversion to a more junior instrument and actions that are considered distressed debt exchanges (DDEs) are all considered to be "non-performance" of a bank hybrid security from a ratings perspective, regardless of contractual treatment. Fitch rates on a "first dollar of loss" principle.

Basis for Notching: Bank hybrid securities are "notched" down from an anchor rating (see below). The number of notches reflects an assessment of loss severity relative to the "average" recoveries assumed for typical bank senior debt (a maximum of two notches) and an assessment of incremental non-performance risk relative to the point at which a bank might be deemed to have "failed" or become "non-viable". These two components are additive.

Influence of Support: In most jurisdictions, Fitch is insufficiently confident that sovereign support will flow through to bank hybrid securities to be able to factor sovereign support into their ratings. Consequently, the anchor rating from which most bank hybrid securities are notched down is a bank's Viability Rating (VR), rather than the bank's Issuer Default Rating (IDR). Fitch's VRs reflect Fitch's assessment of a bank's risk of failing or becoming non-viable and exclude the potential provision of extraordinary support.

Support motivations in certain countries, and situations where the primary source of support is institutional mean there are instances where Fitch might still elect to factor support into a bank hybrid security rating. In such instances, ratings may be notched down from a bank's IDR, its VR or even a parent's VR, depending on the situation.

Gone-Concern Only Loss Absorption: Unless Fitch determines that gone-concern only loss-absorption securities are likely to be supported, they will be rated one notch below an issuer's VR. Such securities include existing/legacy Lower Tier 2 subordinated debt and Basel III compliant "vanilla" Tier 2 debt with non-viability triggers.

Going-Concern Loss Absorption: If going-concern loss absorption (most likely coupon omission) is unrestricted, instruments with this characteristic will usually be rated five notches below an issuer's VR that is in the 'bbb' range or higher (two notches for loss severity and three for non-incremental non-performance risk relative to a bank's VR). Basel III compliant "additional tier 1" securities are expected to fall into this category.

New Instruments that do not have unrestricted going-concern loss-absorption features but achieve this only at a pre-defined trigger (eg, through write-off or equity conversion) will typically be notched three to four notches below an issuer's VR (one notch for loss severity and one to two for incremental non-performance risk relative to the VR). Tier 2 CoCos are expected to fall into this category.

Existing and Legacy Instruments: These securities will generally be rated two to four notches below an issuer's VR, dependent on relative subordination (one to two notches) and loss absorption characteristics and the extent of constraints on loss-absorption features (one to two notches).

Background

Since December 2009, considerable progress has been made by the regulatory community towards redefining bank regulatory capital. Basel III proposals in this regard are currently being processed into regional and national legislative frameworks. Examples include the European Commission's Capital Requirements Regulation proposals and, in Canada, the expectations outlined by the Office of the Superintendent of Financial Institutions (OSFI) with respect to the issuance of non-viability contingent capital.

Although such documents set out the broad framework and minimum standards, a heightened degree of uncertainty remains as to how new generation bank hybrid securities will function in practice. However, it is the clear intent of the regulators that Basel III-compliant capital instruments will be better able to absorb losses than their Basel II antecedents. In this context, Fitch deems empirical performance data from the Basel II era to be of little value in informing the ratings of Basel III instruments.

Scope

This criteria report addresses how Fitch assigns ratings to hybrid securities issued by banks, bank holding companies and by certain securities firms (for example, if they are prudentially regulated in a bank-like manner). Such securities represent junior or subordinated claims against a company and are designed to be available to absorb losses either on a going-concern or gone-concern basis.

Going-concern loss absorption is achieved where loss- absorption features kick in before a bank becomes non-viable and either defaults or avoids default because it is supported. It is most commonly achieved via coupon deferral or omission, but may also include write-down or conversion features. Although going-concern loss- absorption features have often proved ineffective (see *Bank Hybrid Securities: Debt Genes To the Fore During Financial Crisis,* dated 10 February 2011), Tier 1, Upper Tier 2, Basel III Tier 2 CoCos and certain deferrable dated Tier 2 securities (for example, found in parts of Latin America and Asia-Pacific) are examples of instruments with going-concern loss-absorption characteristics.

Gone-concern loss absorption arises where instruments are only designed to absorb losses in an end-game scenario. Lower Tier 2 and Basel III Tier 2 securities are examples of gone-concern hybrid securities. Such securities do not include loss-absorption features (eg ,coupon deferral or write down) that are designed to be activated prior to such a point.

Other Non-Bank Financial Institutions

Going-concern loss-absorption hybrid securities issued by other non-bank financial institutions (eg, finance or leasing companies, asset managers, certain other securities firms) are more likely to be rated in accordance with the principles outlined in the criteria entitled *Treatment and Notching of Hybrids in Corporates and REIT Analysis,* dated 15 December 2011. Gone-concern loss-absorption securities will be rated in accordance with these criteria. Fitch will make it clear in its published research which criteria it is using for assigning ratings to hybrid securities issued by non-bank financial institutions.

The Basis for Notching and the Importance of the Anchor Rating

Notching bank hybrid security ratings down from an anchor rating allows Fitch to express differing levels of investment risk for different classes of obligations/securities from the same borrower. The rating assigned to any given instrument reflects primarily the probability of non-performance relative to the anchor rating *plus* the relative loss severity given non-performance. The two components are additive, and both are relative to the same anchor.

Non-performance risk is essentially "first dollar of loss", often referred to as "probability of default" (PD), although it is important to avoid the term "default" in the context of bank hybrid securities as in a strict legal sense default has a very restricted meaning. In particular, the

Basel III regulations stipulate for Tier 1 instruments that non-payment of a coupon "must not be an event of default".

Non-performance, for Fitch's rating purposes, is defined as any of the following:

- the missing of a coupon;
- contingent contractual conversion into common equity or similar instrument (other than at the option of the investor);
- the write-down or non-payment of principal; or
- a DDE – see Fitch's *Distressed Debt Exchange* criteria, dated August 2011.

There are two particularly important considerations in this approach when it comes to rating banks outlined below.

Ratings Cannot Capture Every Risk Nuance

First, it is likely that within the liability structure of a large bank, there might be a considerable number of different combinations of non-performance risk and loss severity given non-performance. It is not practical within the limitations of Fitch's 19-point rating scale to capture every loss severity or non-performance risk nuance.

Sovereign Support Unlikely for Most Bank Hybrid Securities, Meaning the VR Will Usually be the Most Appropriate Anchor Rating for Notching

The second involves the role of extraordinary state support in sometimes "inflating" the IDR/Senior debt rating (ie, where a bank's IDR is above its VR and is underpinned at its Support Rating floor). Fitch does not factor extraordinary state support into the ratings of bank hybrid securities with going-concern loss-absorption features. As a result, the anchor rating from which such securities are notched down is a bank's VR.

Although specific non-viability triggers will only be a feature of Basel III instruments, Fitch believes that the threat of resolution regimes (whether or not they are yet on the statute book), combined with the established concept of "burden sharing" in respect of regulatory capital instruments, means that the likelihood of either full-blown resolution or some form of DDE has risen in many jurisdictions to a point where the non-performance risk of bank hybrid securities without going-concern loss absorption (ie, Basel III Tier 2 and Legacy Lower Tier 2) should, in most instances, also be linked to the issuer's viability. As a result, Fitch's starting assumption is that bank hybrid securities with gone-concern loss-absorption features will also be notched from its VR.

Nonetheless, Fitch recognises that there are certain jurisdictions where the likelihood of sovereign support is likely to remain sufficiently strong for certain banks for Fitch to continue to factor support into the ratings of bank hybrid securities with gone-concern loss-absorption features. Fitch believes this to be the case for certain banks with state ownership and/or policy roles in China, India, Taiwan, Russia and the Middle East, for example. In such cases, such securities will be notched down from a bank's IDR, but only to reflect relative loss severity.

Anchor Ratings When Hybrids are Issued by a Subsidiary Bank

The risk of non-performance can be very different where a hybrid security is issued by a bank that is a subsidiary of another bank or institution. In such instances, a parent is often highly likely to have a keen interest in supporting a subsidiary and preventing it from hitting points where hybrid loss absorption features kick in. Fitch applies the approach outlined below.

- Where Fitch has concerns over a parent bank's desire to support a subsidiary's hybrid securities or a parent bank has limited ability to neutralise the non-performance risk of a subsidiary's hybrid security (eg, the security has an annual profits test), the bank hybrid security will be notched from the subsidiary's VR.

- Where Fitch believes parental support can and will effectively be used to neutralise the non-performance risk of a subsidiary bank's (with a lower VR) hybrid security, the hybrid is likely to be notched from the subsidiary's IDR, with the notching only reflecting relative loss severity. However, there may also be instances where it is appropriate to cap the banking subsidiary's hybrid security rating at a level that would be assigned to equivalent securities issued by the parent, particularly where the parent and subsidiary operate within the same country.
- Under other circumstances where a subsidiary's VR is higher than its parent's VR, and Fitch believes the parent would be unlikely to (be able to) take actions that materially adversely affect the VR of the subsidiary, it may be appropriate to notch the subsidiary's hybrid securities off its own VR.

Notching for Loss Severity

Loss-severity notching arises because of a higher loss severity relative to the expectation for a senior unsecured instrument in a failing unsupported entity. In the case of below-average recoveries a rating is lowered by one notch from the anchor rating, and in the case of poor recoveries, by two notches (see also Fitch's Ratings Definitions at www.fitchratings.com).

It is important to note that, at issue and while non-performance risk remains low, this element of notching is always based on an end-game scenario, which Fitch assumes to be resolution/liquidation. It is not reduced because the loss severity may be substantially less under a less adverse scenario that may play out ahead of resolution/liquidation, eg, coupon deferral or contingent conversion/write-down. Such considerations only affect an instrument's rating when it is non-performing or when non-performance risk is very high (see *Ratings Life-Cycle and Compression*).

Although in an extremely adverse scenario, all junior creditors of a bank may be completely wiped out, Fitch believes it is appropriate at the initial rating to maintain a degree of rating differential between different types of regulatory capital security to reflect their differing subordination. In broad terms, most Tier 2 instruments are typically notched once for loss severity, and more junior and equity-like Tier 1 instruments are typically notched twice.

Notching for Non-Performance Risk

Going-Concern Loss Absorption

For securities with going-concern loss-absorption characteristics, it is not so much loss severity, as the probability of non-performance relative to hitting the point of non-viability that is the biggest rating variable. Activation of a going-concern loss-absorption feature does not mean a bank has failed, but is treated as "non-performance" at a security level rating.

Fully Discretionary Coupons

Fitch believes fully discretionary coupons will be the most easily activated form of loss absorption, and the key driver of the rating for a Basel III 'Additional Tier 1' instrument for example. Although it is unclear at exactly what point a bank will be "required" by its regulator to omit coupons, it is likely to arise as the bank is entering its capital conservation buffer or any regulatory buffer – whether permanent or temporary – that may apply to that institution. At this point, it will be captured by the Basel definition of "Elements subject to the restriction on distributions" (Basel Para 132 (a)): "items considered to be distributions include dividends and share buybacks, discretionary payments on other Tier 1 capital instruments and discretionary bonus payments to staff".

As the risk of a bank entering into a capital buffer zone is considerably higher than it is of hitting the point of non-viability, bank hybrid securities with fully discretionary coupons will exhibit the widest degree of notching in a bank's liability structure, irrespective of any other features.

Pre-Set Triggers for Contingent Conversion or Principal Write-Down

In addition to fully discretionary coupons, Basel III additional Tier 1 securities must allow principal loss absorption in a going concern through conversion into equity or principal write-down at a pre-determined trigger level that is likely to be hit in advance of the point of non-viability. Given that the most easily activated going-concern loss-absorption feature of such securities should be the coupon omission feature, the level of the contingent conversion/write-down feature is not relevant to their rating.

However, if a bank issues an instrument whose only going-concern loss-absorption feature is a contingent conversion/write-down feature at a pre-determined trigger above the likely point of non-viability (eg, a Tier 2 CoCo), this trigger gives rise to incremental non-performance relative to the bank's VR.

At this stage, it is difficult to know how many such instruments will be issued and what the typical trigger levels will be, both in isolation and relative to the triggers in any additional Tier 1 instruments from the same issuer.

Dependent on the volatility of a bank's earnings, the degree of flexibility in managing risk-weighted assets (RWA) and the projected capital cushion above the pre-determined trigger, Fitch will add either one or two notches for non-performance risk, to which relevant loss severity notches will be added. Until there is greater clarity on the level of triggers that are likely to be set and how they compare to the level of capital banks to which banks operate, Fitch is more likely to err on the side of caution and assign two notches for non-performance risk. Fitch may assign only one notch for non-performance risk where the risk is considered only "moderate", though. One example might be where non-performance risk is cushioned by the existence of a sufficient layer of securities with sufficiently higher triggers.

Legacy Hybrid Securities

With regard to legacy hybrid securities, the market generated a wide variety of terms and conditions in the years preceding the crisis. Indeed, this very complexity has been identified by the regulators as a major shortcoming in the effective functioning of this asset class from a loss-absorption perspective (see *Bank Hybrid Securities: Debt Genes To the Fore During Financial Crisis,* dated 10 February 2011). Furthermore, this complexity posed a major rating challenge.

Although for legacy Tier 1 instruments, in theory, there should have been flexibility over coupon payments, in practice, in the majority of cases this flexibility was severely constrained by a variety of "must-pay" features, not only in the form of look-backs and parity security clauses, but also in the existence of deferral triggers set at or very close to the prevailing regulatory minima, which conversely mandated payment so long as the trigger was not breached. The risk of DDEs, for example, cut through this complexity to a significant degree, but not completely, meaning a limited degree of flexibility is warranted in rating such securities.

The combination of residual coupon-deferral risk and the potential vulnerability to a DDE means that Fitch regards many legacy Tier 1 instruments as exhibiting high relative risk of non-performance. To reflect this, Fitch's base expectation is that it will assign two notches for incremental non-performance risk. However, for example where constraints to non-performance are judged to be very high (especially if this has been tested), Fitch may decide to assign only one notch for non-performance risk.

In respect of their non-performance risk, legacy Upper Tier 2 instruments are subject broadly to the same considerations as legacy Tier 1 instruments, so the same approach will be adopted by Fitch when assigning notches for non-performance risk.

Fitch will rate dated subordinated instruments with cumulative coupon deferral (as found in some countries in Latin America and Asia-Pacific, for example) in the same way as it rates Upper Tier 2 securities.

Gone-Concern Loss Absorption

Non-Viability Triggers

Fitch regards the non-performance risk inherent in a non-viability trigger to be the same as that expressed in the Fitch VR. As such, there is no incremental notching for non-performance required because of the existence of a non-viability trigger. The notching from the VR of vanilla Basel III Tier 2 debt, where no other loss-absorption features beyond those related to non-viability are present will solely reflect incremental loss severity.

For other gone-concern instruments without explicit non-viability write-down triggers, as there is also not enough incremental performance risk relative to the point of non-viability to justify any notches for non-performance risk, such securities will also be notched only for loss severity.

Ratings Life-Cycle and Compression

Hybrid Ratings When VRs Are 'bbb−' or Higher

Fitch's baseline approach to rating bank hybrid securities issued by banks with VRs of 'bbb−' or higher is detailed in Figure 1. Fitch believes the majority of new bank hybrid securities with going-concern loss-absorption characteristics will be issued by banks that are highly rated on the VR scale. It should be noted that Fitch rates to the core features of the instrument, rather than its regulatory capital treatment. For example, a legacy Tier 1 instrument with full effective coupon discretion will be rated five notches below a bank's VR.

Fitch also expects that banks will only issue hybrid securities where, at the date of issue, the probability of non-performance in absolute terms is relatively remote. In the event that a bank issues a new going-concern loss-absorption instrument with a relatively high probability of non-performance from the outset, Fitch would probably apply substantially wider notching than set out in Figure 1. In extreme cases where, in Fitch's view, non-performance of a new instrument in the near to medium term was virtually inevitable, Fitch would probably refuse to rate such an instrument, as it would essentially be equity-like from the outset.

Tier 1 hybrid securities with easily activated loss absorption triggers such as annual profits tests will be rated at least 5 notches below an issuer's VR.

When VRs Are 'bb+' or Lower

Because of the numerical limitations of Fitch's 19-point rating scale and the fact that Fitch assigns ratings on the same scale to both performing and non-performing securities, rigid adherence to the notching outlined in Figure 1 could lead to undesirable ratings compression

Figure 1

Rating Guidelines When VRs Are 'bbb−' or Higher

Core Features driving the rating	Example instrument	Loss severity	Notches for loss severity relative to average recoveries	Non-performance risk relative to VR	Notches for non-performance	Total notches from VR
Deep subordination; fully discretionary coupon omission	Basel III Tier 1	Poor	-2	Very high	-3	-5
Subordination; no coupon flexibility; non-viability language (contractual or statutory)	Basel III Tier 2	Below average	-1	Minimal	0	-1
Subordination; no coupon flexibility; going-concern write-down or conversion trigger	Basel III Tier 2 with going-concern CoCo	Poor	-2	Moderate or High	-1 or -2	-3 or -4
Subordination; no coupon flexibility	Legacy Tier 2	Below average	-1	Minimal	0	-1
Subordination; cumulative coupon deferral, often constrained;	Certain legacy UT2/deferrable LT2	Below average	-1	Moderate or High	-1 or -2	-2 or -3
Deep subordination; non-cumulative coupon deferral, often constrained	Certain legacy Tier 1	Poor	-2	Moderate or High	-1 or -2	-3 or -4

Source: Fitch

where banks' VRs are 'bb+' or lower. Fitch will use therefore the following baseline matrix to determine ratings, when an issuer's VR is 'bb+' or lower.

The trajectory of an issuer's VR and other specific aspects such as the complexity and characteristics of an issuer's capital structure will influence whether Fitch applies the maximum rating under the matrix or something lower. For example, an emerging-market issuer with a long track record of relatively stable creditworthiness and low leverage may have a 'bb' range VR to reflect country risks, size and diversification constraints, etc. The risk of hybrid non-performance may be considered lower than for an issuer with the same VR, but whose VR is on a downward trajectory and where hybrid non-performance is becoming an increasing possibility in order to preserve capital, to satisfy a regulator, etc. In such cases, a similar hybrid issued by the former bank may be rated higher than one issued by the latter, especially if Fitch considers the risk of a regulator enforcing or coercing a bank to activate loss absorption measures to be lower.

Figure 2

Rating Guidelines where VRs are bb+ or lower

	bb+	bb	bb-	b+	b	b-	ccc, cc, c
Subordination; no coupon flexibility	BB	BB-	B+	B [a]	B- [a]	CCC [a]	CC [a]
Subordination; no coupon flexibility; non-viability language	BB	BB-	B+	B [a]	B- [a]	CCC [a]	CC [a]
Subordination; cumulative coupon deferral; often constrained	BB- [a]	B+ [a]	B [a]	CCC [a]	CCC [a]	CC [a]	C
Subordination; no coupon flexibility; going-concern write-down/conversion trigger	BB- [a]	B+ [a]	B [a]	CCC [a]	CCC [a]	CC [a]	C
Deep subordination; non-cumulative coupon deferral; often constrained	B+ [a]	B*	B- [a]	CCC [a]	CCC [a]	CC [a]	C
Deep subordination; fully discretionary coupon omission	B [a]	B- [a]	B- [a]	CCC [a]	CCC [a]	CC [a]	C

[a] maximum rating
Source: Fitch

When Relative Non-Performance Risk Increases

A downgrade of a bank's VR will not usually affect the notching of the securities relative to the VR. Notching may however change where the probability of non-performance on its hybrids relative to the probability of it hitting its point of non-viability increases. This might reflect a change in capital management or an unexpected shift in regulatory buffers, for example. In another instance, slow-burn capital erosion may be occurring to a degree that Fitch is increasingly concerned about the coupon non-performance risk on Tier 1 instruments, but not to a degree that gives rise to particularly material incremental risk of breach of high conversion triggers in Tier 2 CoCos.

In such instances, bank hybrid security ratings will be treated on a more bespoke basis, dependent on Fitch's assessment of securities' non-performance risk, i) given the situation that is evolving for the bank in question and ii) giving consideration to the likely rating level should it become non-performing (see below).

When Issues Become Non-Performing

Once an issue becomes non-performing in any way, the ratings take into consideration the form and expected duration of loss absorption. Factors considered include the level of a bank's VR and the type of loss absorption being suffered (eg, cumulative coupon deferral against coupon omission and any mitigating factors, temporary or permanent write-down, etc.). Non-performing instruments are assigned ratings in accordance with Figure 3. The rating will be based on the net present value of expected cash flows and the VR of the issuer.

Figure 3

Ratings of Non-Performing Hybrid Obligations

Obligation Rating	Non-Performing Obligation
B Category	Loss absorption has been triggered, but the rated obligation is expected to return to performing status with only very low economic losses being sustained that are consistent with RR1 Recovery Ratings. VR is no lower than the 'bb' range.[a]
CCC	Loss absorption has been triggered, but the rated obligation is expected to return to performing status with only moderate economic losses being sustained that are consistent with RR2 Recovery Ratings. VR is no lower than 'b'.
CC	Loss absorption has been triggered, and the rated obligation is only expected to return to performing status with high economic losses being sustained that are consistent with RR3 Recovery Ratings. VR is no lower than 'b-'.
C	Loss absorption has been triggered, and the rated obligation is only expected to return to performing status with severe economic losses being sustained that are consistent with RR4-RR6 Recovery Ratings.

[a] If loss absorption is in the form of cumulative deferral that is expected to be short-lived (eg, six months or one annual coupon) or is effectively mitigated by a feature such as an alternative coupon satisfaction mechanism (ACSM), Fitch will typically lower the rating to no higher than 'BB' or, in exceptional circumstances 'BBB'.
Source: Fitch

When Issues Become Performing Again

Once an issue becomes performing again, it will effectively be re-rated in line with the approaches outlined in Figures 1 and 2.