# ARCHIVE: TRC Financial Services Sector Issue Credit Rating Criteria

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*(Editor's note: This criteria article is no longer current. It has been superseded by the article 'TRC Financial Services Issue Credit Rating Criteria' published on July 31, 2019.)*

1. Taiwan Ratings Corp. (TRC) is refining its issue credit rating criteria to provide guidelines on the issue credit rating of financial services sectors by adding the revised bank hybrid criteria rating methodology (in section B below). This article is related to S&P Global Ratings' criteria articles "Hybrid Capital Handbook September 2008 edition," published on Sept. 15, 2008, "Methodology: Use Of 'C' And 'D' Issue Credit Ratings For Hybrid Capital And Payment-In-Kind Instruments," published on Oct. 24, 2013, "Principles For Rating Debt Issues Based On Imputed Promises," published on Dec. 19, 2014, and "Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions," published on Jan. 29, 2015.

## SCOPE OF THE CRITERIA

2. The criteria apply to all existing and future issue credit ratings on bonds issued by financial services sectors. Section A below indicates general guidelines on financial services sector hybrid capital ratings and remains mostly unchanged, while the newly added section B applies to bank hybrid capital ratings.
3. The term "banks" includes finance companies, securities firms and nonoperating holding companies whose main subsidiaries are banks, while the term "nonbank financial services sector" includes insurers (and asset managers and exchange and clearing houses) and nonoperating holding companies whose main subsidiaries are insurers. In aggregate, this is the "financial services" sector for the purpose of these criteria.
4. The criteria describe how, for obligations issued by financial services sectors, issue credit ratings may be equivalent to or notched down from the issuer credit rating (ICR) or the stand-alone credit profile (SACP) as a result of several analytical considerations.
5. The criteria are related to only long-term issue credit ratings on the TRC scale and do not affect any S&P Global Ratings' global scale ratings assigned to Taiwanese issuers. The notching process will be based from the ICR of the TRC scale ratings or the SACP, rather than the S&P global scale ratings unless specifically mentioned in the criteria. Moreover, the criteria do not address short-term ratings or other non-TRC scale ratings.

## IMPACT ON OUTSTANDING RATINGS

6. This criteria revision will result in the lowering of the majority of issue credit ratings on hybrid capital instruments defined as Tier 1 within the issuing banks' regulatory capital.

## EFFECTIVE DATE AND TRANSITION

7. The revised criteria are effective immediately.

## METHODOLOGY

### Rating The Issue

8. In the financial services sectors, TRC assigns two types of credit ratings--one to issuers and the other to individual issues. The first type is called an issuer credit rating (ICR). It is a forward-looking opinion about the overall creditworthiness of a debt issuer, guarantor, insurer, or other provider of credit enhancement ("obligor") to meet its financial obligations as they come due, relative to other Taiwanese obligors. In contrast, while issue credit ratings address timeliness, they also address the relative ranking in bankruptcy and loss absorption (including coupon nonpayment) risk on instruments where this is allowable. Finally, SACP in this article refers to TRC's opinion of an issuer's creditworthiness, in the absence of extraordinary intervention from its parent or affiliate or related government; it is but one component of a rating. We use lowercase symbols, for example 'twaaa', or 'twaa', to designate SACPs, and may modify this symbol with a "+" or "-" sign, depending on the specificity of the relevant analysis. SACPs do not have outlooks and are not placed on CreditWatch. We do not consider SACPs to be ratings. An SACP is set at the level correlated with the S&P Global Ratings' SACP on the issuer.

9. In Taiwan, the issue credit ratings are assigned to conventional debt issues (i.e., senior unsecured instruments), conventional subordinated debt, and hybrid capital instruments. The analysis of specific instruments includes consideration of priorities within an obligor's capital structure and the potential effects of collateral and recovery estimates in the event of the obligor's default. Usually, for obligors other than insurers (where senior bonds are subordinated to policyholders) and entities in default on selected obligations, senior unsecured debt across Taiwan's financial service sectors is rated the same as the ICR on the respective obligor, because the debt are ranked pari passu with the obligor. The analysis may apply notching to instruments that rank below their obligor's senior, unsecured debt, such as subordinated debt instruments.

10. Hybrid capital instruments may afford equity benefit to issuers by having ongoing payment requirements that are more flexible than interest payments on conventional debt, by otherwise potentially absorbing losses by write-down or conversion to common equity, and by being contractually subordinated to such debt. In our view, these characteristics make the instruments riskier for investors than conventional debt. In assigning issue credit ratings to hybrid capital instruments, we seek to assess the incremental risks associated with the instrument in terms of timeliness and completeness of coupon and principal, as well as subordination, compared to the ICR and to nondeferrable conventional debt. We reflect these risks in the ratings of hybrid capital instruments by assigning them ratings that are "notched down" from the ICR or SACP. Owing to the uncertain nature of some of the risks to which hybrid capital instruments are subject, the ratings are potentially more volatile than the ratings on conventional debt issues. In certain circumstances, where an issuer is experiencing deteriorating credit quality, we may decide to widen the gap between the ICR or SACP and hybrid capital issue ratings.

### A) Nonbank Financial Services Issue Credit Ratings

Unless one or more of section A1, A2 or A3 apply, the issue credit rating is at the level of the ICR.

#### A.1. Rating The Issue: Subordination

11. Subordination adversely affects the ultimate recovery prospects of subordinated obligation holders in a bankruptcy, since claims of priority creditors must be satisfied first. For issuers rated at 'twBBB-' or above, we assign a rating one notch below the ICR for issues that are subordinated but do not absorb losses before the issuer defaults. In the case of issuers rated at 'twBB+' or below, we systematically rate the issue two notches below the ICR just to reflect subordination, that is, apart from any incremental

notching for loss-absorption risk. The notching differential for subordination reflects the weaker recovery prospects for subordinated debt in an issuer default. Moreover, when subordinated debt has a greater likelihood of being rated 'D' than senior debt--either because of specific features in law that limit the circumstances under which subordinated debt can be serviced or because of covenants in the subordinated debt that establish capital or earnings tests that must be met before payment can be made--ratings differentials would usually be wider to reflect the incremental default risk.

12. We do not distinguish in the notching between gradations of subordination: non-loss absorbing junior subordinated issues and senior subordinated issues are rated the same. Global experience has shown that, in bankruptcy, ultimate recoveries for different classes of subordinated instruments tend to be similar and poor. Also, other things being equal, we don't distinguish between hybrid capital issues that are cumulative and those that are noncumulative, since there is little reason to suppose the recovery prospects of the two are materially different in bankruptcy.

13. When a nonoperating holding company issues debt, as is common in Taiwan in our experience, the notching is relative to our ICR on the holding company, which is typically lower than the ICR on the main operating unit.

### A.2. Rating The Issue: Coupon Nonpayment

14. Payment risk can be heightened in the case of hybrid capital instruments due to:

- The right of optional coupon nonpayment, where management has the option under the terms of the instrument to suspend or cancel distributions without triggering a default;
- Mandatory coupon nonpayment, where, with the breaching of one or more predetermined triggers, the issuer is required to suspend payments; and
- Regulators' ability, in certain cases, to order companies to defer or cancel payments.

15. Our objective is to reflect coupon payment risk in hybrid capital instruments credit ratings, whatever the potential driver of the nonpayment. As nonpayment becomes an increasingly likely prospect, the differential between the ICR and the issue rating on the hybrid capital instrument would widen to reflect the heightened risk of deferral.

#### Optional coupon nonpayment

16. We assume that issuers will be reluctant to exercise their right of optional coupon nonpayment, given the negative reaction this evokes among investors and hence the ramifications it can have for the issuer's future access to capital markets. Payment risk is heightened when the issuer faces increased prospects of financial distress, such that management's reluctance to defer or cancel coupon payments may ultimately be overcome in favor of the need to conserve cash. As referred to above, the "pressure points" may differ for different types of issuers, meaning the consideration of coupon nonpayment may come at earlier or later stages in the course of credit deterioration. One danger sign is when a company curtails or eliminates its dividend on common stock: This is sometimes a precursor to a coupon nonpayment on equity hybrids.

#### Mandatory coupon nonpayment

17. Triggers for mandatory coupon nonpayment vary. Some consist of earnings-, cash flow-, or capitalization-based financial ratio tests; others refer to the issuer's incurrence of a loss during a defined period or the failure to meet specified minimum regulatory capital requirements. Still others tie the payment of the distribution on the equity hybrid directly to the company's payment of the common stock dividend.

18. Obviously, the coupon payment risk for the hybrid capital issue investor is higher when it would take only a minor and temporary shortfall in profitability to cause the deferral, for example. On the other hand, if it

would take circumstances so dire for the trigger to be breached that the issuer would likely be on the brink of bankruptcy, then the payment risks for the hybrid capital issue investor would not be materially different than they would be for debt holders.

### Regulatory coupon nonpayment

19. In some regulated financial services sectors, regulators have the authority to direct companies to defer or cancel payments on hybrids based on the regulators' own assessment of what is prudent. In certain cases, regulated issuers have been ordered to stop coupon payments even when they met all regulatory capital requirements. Assessing the risk of coupon nonpayment in the case of a regulated company requires careful consideration of sector- and country-specific factors, including precedents of coupon nonpayment ordered by the regulatory body in question. Especially important is the identification of financial measures to which the regulator is particularly sensitive.

20. The authority and intent of financial regulators to order nonpayment of payments in certain circumstances--whether or not clearly defined--means that most hybrid capital securities of regulated financial institutions can be viewed as having de facto mandatory coupon nonpayment. Regulated financial institutions structure hybrids according to rules established by national regulators for regulatory capital measures. This includes the definitions of the capital ratios or performance measures that would trigger payment coupon nonpayment if breached. The triggers for coupon nonpayment--typically the regulatory minimum capital ratio for insurers and holding companies--are usually made explicit in the covenants of the hybrid security. Less often, the trigger is not explicit in the document but is understood by both issuer and regulator.

### A.3. Rating The Issue: Factoring Payment Risk Into Issue Credit Ratings

21. In reflecting payment/deferral risk in hybrid capital instruments credit ratings, we evaluate the different sources of deferral risk that are present and seek to assess their combined significance. Where deferral is possible but we believe the prospect of a deferral is relatively remote for the foreseeable future, the notching for this feature is one notch from the ICR or SACP in setting the issue credit rating, whatever the ICR or SACP levels, with a floor at 'twC' (subordination will increase the notching, as explained in the prior section). A one-notch differential to factor in payment risk alone is the typical treatment for instruments that have optional deferral alone. For example, the subordinated and optionally deferrable instrument of an issuer rated 'twBBB+' or with an SACP of twbbb+ would generally be rated 'twBBB-' (one notch for subordination and one notch for payment deferral risk). If the instrument were senior and deferrable (a rare but possible combination), the same obligor's instrument would be rated 'twBBB'. We take the same approach even at the highest rating levels (note that a subordinated and deferrable issue of an issuer rated 'twAAA' or with an SACP of twaaa is typically rated 'twAA', because there is no 'twAAA-' rating in our rating scale, 'twAA' is two notches below 'twAAA'.)

22. When we have heightened concerns that the issuer may defer--whether due to the exercise of its right to defer optionally, the breaching of a mandatory deferral trigger, or the exercise of a regulator's prerogatives--we increase the gap between the ICR or SACP and the issue credit rating. We do not impose any arbitrary limit on the size of the gap. On the other hand, if the issuer faced the immediate prospect of financial distress, yet we believed management remained determined--for whatever reason--not to exercise the right to optionally defer or cancel the coupon, we could potentially narrow the notching for payment risk.

23. Combinations of different forms of coupon nonpayment clauses may or may not increase payment risk. For example, if an issue has mandatory and optional coupon nonpayment clauses and the mandatory triggers are defined so that they could be breached without there necessarily having been fundamental erosion in the issuer's credit quality, then the risks to investors would be greater than if there were an optional coupon nonpayment clause alone. The same would be true if the triggers were more reflective of fundamental credit quality, but could be breached before the point where the issuer would contemplate

optional coupon nonpayment. In either of these cases, a lower issue credit rating would be warranted than if there were optional coupon nonpayment alone. In these circumstances we generally add to the gap between the issue credit rating and the issuer credit rating. On the other hand, if the mandatory trigger were sufficiently remote that we believed it would be unlikely to be breached before the company would otherwise have optionally stopped coupon payments, then we would not take away additional notches for the mandatory coupon nonpayment clause compared to what would be appropriate for the optional coupon nonpayment clause alone.

24. Some issues with mandatory coupon nonpayment clauses have clauses that require the issuer to undertake the sale of common or preferred stock and utilize the proceeds to make the distribution in cash to hybrid instrument holders. If the payment can be made on a timely basis, we would not view this as a default. However, there is the risk that the company would be unable to complete the required share issuance, depending on the company's circumstances and conditions in the capital markets. So far, in Taiwan we have not notched down a second notch for a mandatory coupon nonpayment clause in cases where "best efforts" share issuance (or issuance of other securities) would then be immediately required. However, we could reassess this approach as we gain more insight into the practicability of this requirement. In any event, we will notch down when we believe that under the most likely scenario where a coupon nonpayment could occur, the issuer's financial strength and share price would have declined so much as to make the issuer's ability to complete the necessary common stock issuance (or issuance of other securities) uncertain.

25. In the case of regulated financial services issuers, explicit mandatory deferral triggers do not add to payment risk stemming from regulation if--as is generally the case--the triggers just replicate the capital standards that a regulator applies in determining whether to order a deferral.

## B) Bank Hybrid Capital Ratings

26. The criteria for rating a bank hybrid capital instrument apply to all such instruments, regardless of their equity content classification, and also apply when a hybrid capital instrument is not part of regulatory capital. Section B.4 describes the criteria for nondeferrable subordinated debt instruments that are not classified as hybrid capital instruments.

27. We do not rate an instrument that has a loss-absorption or contingent capital trigger that is not related to the bank's creditworthiness, in line with "Principles For Rating Debt Issues Based On Imputed Promises," published Dec. 19, 2014 by S&P Global Ratings. Examples of such triggers are those linked to a bank's market capitalization or share price. We will also not rate instruments with triggers that are based on regulators' concerns about financial stability in the broader market, or to events or situations that are not observable using public information. This includes situations in which a regulator has full discretion to activate the trigger when a bank is still a going concern. However, if the regulator's discretion only extends to deciding whether a bank is about to breach a defined and observable regulatory ratio, or only to deciding whether a bank is nonviable, then the instrument is a nonviability contingent capital (NVCC) instrument and is ratable.

### B.1 Starting point for standard notching

28. We assign an issue credit rating to a bank's hybrid capital instrument by notching down from the assessment of the bank's SACP, except in the situations described in paragraphs 29-35 when notching is from the ICR. The reason for this is that the ICR may include notches of uplift for our expectation of extraordinary group or government support to the bank in the event of distress, but when this support does not accrue to hybrid capital instruments then we notch from the SACP.

29. If we classify a bank subsidiary as "core", "highly strategic," or "strategically important" under our Group Rating Methodology, published Nov. 19, 2013, the following rating approach applies:

- The issue credit rating results from notching down from the ICR on the subsidiary if group support also applies to the subsidiary's hybrid capital instruments.
- If we do not expect group support to maintain payments on the subsidiary's hybrids and prevent loss absorption by a hybrid capital instrument, then the issue credit rating on the hybrid instrument results from notching down from the SACP of the subsidiary.
- If the parent company is an operating entity rather than a nonoperating holding company (NOHC), the issue credit rating on a subsidiary's hybrid capital instrument is capped at (but can be lower than) the issue credit rating on an otherwise identical hybrid capital instrument issued by the parent operating entity. This is unless the ICR on the subsidiary is higher than that on the parent operating entity, in which case the cap does not apply. If the parent has not issued a similar instrument, the cap is the issue credit rating that would have applied if the instrument had been issued by the parent operating entity.

30. The issue credit rating on an NOHC's hybrid capital instrument results from notching from the ICR on the NOHC. The criteria cap the issue credit rating at one notch lower than the rating the instrument would have received if the operating bank had issued it. This is because we do not assign an SACP to an NOHC. The ICR on an NOHC reflects the NOHC's relationship with the wider group and our group credit profile assessment.

31. If the ICR on the NOHC is more than one notch lower than that on the operating bank, the gap between the ICR and the issue credit rating on the hybrid widens.

32. We also apply this principle to an NOHC's contingent capital instrument because of the heightened likelihood that default on such an instrument would occur before the default on an equivalent instrument issued by the operating bank. This is the case even if both instruments have the same mandatory contingent capital trigger, because the servicing of the NOHC's instrument depends on dividend flows from the operating bank.

33. To rate a hybrid capital instrument of a bank that is a government-related entity (GRE), the notching is from the bank's SACP. However, notching is from the ICR if both the likelihood of government support under our GRE criteria is "almost certain," "extremely high," or "very high," and we consider that financial support from the government would prevent loss absorption (either in the form of coupon nonpayment, a principal write-down, a conversion into common equity or a distressed exchange), by the hybrid capital instrument (see "Rating Government-Related Entities: Methodology And Assumptions," published Dec. 9, 2010 by S&P Global Ratings).

34. If the ICR on a bank is lower than the SACP, which can occur for example if the sovereign rating or transfer and convertibility assessment is lower than the SACP, then the rating approach is to notch down from the ICR.

35. Assigning a rating to a bank hybrid capital instrument comprises two main steps, in both of which we deduct notches from the starting point (either the SACP or ICR) to arrive at the issue credit rating. The gap between the issue credit rating and the SACP or ICR is the sum of the notches deducted in each step:

    - Standard notching, based on relatively common features of hybrid capital instruments; and
    - Additional notching, for specific risk factors not captured in the bank's SACP or the standard notching.

36. See "Methodology: Use Of 'C' And 'D' Issue Credit Ratings For Hybrid Capital And Payment-In-Kind Instruments," published Oct. 24, 2013, and "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings," published Oct. 1, 2012 by S&P Global Ratings, for the criteria determining when a hybrid capital instrument receives those issue credit ratings, and where the rating outcome using paragraphs 38 to 52 does not apply. We assign a rating at the level of the correlation related to a 'CCC+' or lower

global-scale rating when standard, minimum notching for subordination leads to a rating in that category, or when the likelihood of nonpayment on such an instrument is consistent with the scenarios outlined in those criteria articles (see "Credit FAQ: Applying "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings" To Subordinated And Hybrid Capital Instruments," published July 16, 2014 by S&P Global Ratings, for more details).

37. Through paragraphs 38 to 52, notching is applied in the following way:

1. First, we establish, on the global scale, the rating level that reflects the default risk of the instrument.
2. Second, such a rating level on the global scale is used to correlate to the indicative national scale rating.
3. Third, we apply incremental notches down from the indicative national scale rating to reflect subordination.
4. In some cases we cap the global scale hybrid capital instrument's issue credit rating at 'CCC', in which case the national scale credit rating would be capped at the correlation related to 'CCC'.

### B.2. Standard notching for loss absorption

38. The rating methodology for all bank hybrid capital instruments starts with standard notching. Depending on an instrument's features, additional notching may apply (see section B.3). The standard notching for loss absorption for a bank hybrid capital instrument is the number of notches resulting from the correlation between the global scale and the TRC scale of the sum of:

- One or two notches for the risk of a partial or untimely payment, depending on the regulatory classification of the instrument (see step 1a); and
- One notch if there is a mandatory contingent capital clause leading to conversion into common equity, a principal write-down, or both, which would move the issue credit rating to 'D' if triggered (see step 1b)

#### Step 1a

39. To reflect the standard risk of coupon nonpayment, on the global scale we deduct either one or two notches depending on the instrument's regulatory classification.

40. We deduct two notches on the global scale for a regulatory Tier 1 instrument issued by a bank that is subject to or in a jurisdiction that is planning to adopt the general provisions of Basel III or equivalent rules. These entail heightened potential for coupon nonpayment on a going-concern basis when the regulatory "capital conservation buffer" as defined under Basel III, systemically important financial institution buffers, or other regulatory core equity capital buffers apply. This is because of the increased risk of mandatory loss absorption under Basel III and equivalent rules. We deduct these two notches for regulatory Tier 1 instruments issued under Basel III provisions or equivalent rules, or in a jurisdiction that is planning to adopt these provisions, and for legacy Tier 1 instruments that are now subject to those provisions.

41. The risk of mandatory loss absorption is lower for a Tier 1 instrument that is not subject to Basel III mechanisms, or for a regulatory Tier 2 instrument with a deferrable coupon, for which we deduct one notch on the global scale to reflect the standard risk of coupon nonpayment. We also deduct one notch on the global scale for legacy Tier 1 instruments that are not subject to the general provisions of Basel III or equivalent rules and where the issuer is not in a jurisdiction that is planning to adopt these or equivalent measures. Conversely, under step 1a there is no deduction for a Tier 2 instrument that has a nondeferrable coupon.

42. We use the same notching approach as for Tier 1 instruments for an instrument that the regulator classifies as partly Tier 1 capital and partly Tier 2, or a Tier 2 instrument for which the nonpayment of the coupon is linked to nonpayment on a Tier 1 instrument. We deduct two notches on the global scale when Basel III provisions apply or are planned to be adopted (and one notch otherwise), even if a bank hybrid capital instrument has a restricted ability to stop coupon payments, such as due to a clause that prevents coupon suspension because of interactions between coupon payment dates. We still deduct one notch on the global scale for nonpayment risk if the restriction prevents coupon nonpayment because these instruments offer a bank the legal right to stop paying coupons. If coupon nonpayment can only occur when a bank breaches its minimum regulatory capital requirements, we still deduct the relevant number of notches on the global scale for a Tier 1 or Tier 2 instrument. If a hybrid capital instrument is not classified as Tier 1 or Tier 2 regulatory capital (for example because it is issued by a finance company or securities firm that is not subject to such classifications) but has a deferrable coupon, then under step 1a we deduct in total one notch on the global scale for the standard risk of coupon nonpayment.

### Step 1b

43. We deduct a notch on the global scale under step 1b if a contingent capital clause requires the mandatory conversion of an instrument into common equity or write-down of principal, or if there is a discretionary contingent capital clause that we expect regulators to enforce. This is the case if the instrument's documentation includes such a clause or if the relevant regulatory or legal framework implies the equivalent of such a clause. Step 1b applies for such going-concern or nonviability contingent capital clauses unless (1) we evaluate that the regulatory environment in which the issuer bank operates is such that, upon distress, the bank is likely to receive government extraordinary support in a preemptive manner at a relatively early stage of its deterioration and (2) based on relevant regulator announcements, such preemptive government support would not constitute a nonviability event in that jurisdiction and therefore would not lead to a principal write-down or equity conversion of the hybrid. We also do not deduct a notch if a contractual clause is both discretionary and we do not expect regulators to enforce it

### B3. Additional notches to reflect the risk of a partial or untimely payment

44. Additional notching indicates loss-absorption risk that the SACP assessment or criteria for standard notching do not fully capture.

### Step 2a

45. If a hybrid capital instrument has a mandatory going-concern contractual clause or a statutory nonpayment clause linked to a regulatory capital ratio in the form of a specific number, we deduct notches under step 2a to factor in the difference between our expectations of a bank's regulatory ratios and the regulatory ratio level that triggers the nonpayment (on the global scale: one notch for a difference of 301 to 700 basis points (bp); two for 201-300 bp, four for 200 bp, additionally capping--for a difference at 100bp or below--at the correlation related to a 'CCC' global scale rating). Note that step 2a would apply in addition to step 1b for such an instrument.

46. Notching under step 2a applies if the trigger results in nonpayment of coupons, or if the trigger is a contingent capital trigger that leads to a principal write-down or conversion into common equity. In these cases, we base the issue credit rating on our expectation of the regulatory ratio the bank can maintain for the subsequent 12-24 months, in line with the time frame for the rating outlook on the ICR; our expectation may differ from the bank's forecasts.

47. The issue credit rating reflects the capital ratio range that captures the lowest capital ratio that we expect during this time frame, or a higher capital ratio if we strongly expect that capital will strengthen imminently in response to actions the bank has announced. If the trigger relates to compliance with a

minimum regulatory capital requirement to maintain a banking license, it is a nonviability trigger and step 2a does not apply.

### Step 2b

48. Under step 2b, we deduct one, two, or three notches on the global scale for loss-absorption risks that the SACP assessment, standard notching, or the notching in step 2a do not capture. This applies whether the loss absorption would be via coupon nonpayment, write-down, or conversion of the principal into common equity. What follows is a non-exhaustive list of examples of such situations:

- If a bank's reporting of a loss in a particular accounting period leads to mandatory nonpayment on an instrument and the bank is therefore unable to use its reserves to offset the impact of this loss, we typically deduct one notch on the global scale. This can increase to two or three notches, depending on our assessment of the likelihood of the clause being triggered.
- If we consider that a bank is at risk of insufficient distributable reserves for a regulator to permit payment on a hybrid capital instrument--even though nondistributable reserves are available--we typically deduct one notch on the global scale. This can increase to two or three notches, depending on our assessment of the likelihood of the clause being triggered.
- If there is a risk of a statutory or regulatory ruling that prohibits or restricts coupon payments, we generally deduct one notch on the global scale. This can increase to two or three notches, depending on our assessment of the likelihood of nonpayment on the instrument. An example of such a situation is when the European Commission requires a bank to stop coupon payments or otherwise bail-in bank hybrid capital instruments after ruling that the bank had received state aid.
- If we see a heightened risk of a bank or regulator activating a discretionary nonpayment clause--for example, when a bank's regulatory capital position means that it is at heightened risk of being subject to the capital distribution restrictions applicable for ratios within the ranges specified by the Basel III's capital conservation buffer--we generally deduct one notch on the global scale. This can increase to two or three notches, depending on our assessment of the likelihood of nonpayment on the instrument. This notching typically applies only to hybrids issued by banks whose regulatory capital levels are within the buffer ranges. However, we would also apply this notching if we see a heightened risk that a bank's regulatory capital would fall into the capital conservation buffer range applicable for that bank, and that this would trigger a decision by the bank or regulator to stop payments

### Step 2c

49. We cap at the correlation related to a 'CCC' global-scale rating the issue credit rating on a bank hybrid capital instrument with a contingent capital trigger that is linked to a specific rating.

### Step 3

50. Debt subordination results in a one-notch deduction to derive the issue credit rating if the bank's SACP is at 'twbbb-' or higher. An additional notch for subordination applies if the SACP is at 'twbb+' or lower, but the rating is no lower than 'twC' unless 'D' applies. This notching applies whenever an instrument is subordinated to senior unsecured debt, even if it is labeled as mezzanine instead of subordinated.
51. There is no further deduction to reflect different subcategories of contractual subordination if a bank is in liquidation.
52. If notching is from the ICR, the standard deduction for subordination is one notch if the ICR is 'twBBB-' or higher, or two notches if the ICR is 'twBB+' or lower.

### B4. Nondeferrable subordinated bank debt

53. The issue credit rating on a bank's conventional nondeferrable subordinated debt obligation (by conventional we mean that it has the same default risk as senior debt and has no contingent capital clause) is one notch below the ICR if the ICR is 'twBBB-' or higher. The issue credit rating is two notches below the ICR if the ICR is 'twBB+' or lower, but is no lower than 'twC' unless 'D' applies. The criteria assign an issue credit rating of 'D' only to an instrument that has stopped paying.

54. The notching described in the previous paragraph reflects that the default risk for the subordinated instrument is the same as that on senior debt. The issue credit rating also reflects the instrument's subordinated position in an administration, an insolvency, or similar proceedings.

55. If a nondeferrable subordinated debt instrument has a mandatory contingent capital feature (either contractual or statutory), then we rate it according to paragraphs 38 to 52.

56. We take a different approach if a nondeferrable subordinated debt instrument constitutes part of a bank's regulatory capital and represents higher default risk than the senior debt due to a discretionary contractual or statutory contingent capital feature or resolution regime arrangements. This occurs in countries where the regulatory and legal frameworks, including bank resolution regimes, could lead to the conversion of nondeferrable subordinated debt into bail-in capital, or to untimely or partial payment of coupon or principal, without provoking a legal default or the bank's liquidation.

57. In a country where the features in the previous paragraph apply, the approach to rating nondeferrable subordinated bank debt is to notch down from the SACP, using the notching for subordination risk (see paragraphs 52-54). In such jurisdictions, the government is unlikely to support the payment of nondeferrable subordinated debt, even though it may support a bank's senior debt. This makes the bank's SACP the appropriate starting point for the issue credit rating on nondeferrable subordinated debt. Such instruments receive issue credit ratings that are one notch below the SACP if the SACP is at 'twbbb-' or higher, or two notches below the SACP if the SACP is in the 'twbb+' category or lower. But the rating is no lower than 'twC' unless 'D' applies. We assign an issue credit rating of 'D' only to an instrument that has stopped paying.

58. Identification of the jurisdictions in which this notching applies relies on whether the legal and regulatory frameworks allow the authorities to instigate restructuring of a failing bank, to the detriment of nondeferrable subordinated debt. An example of such an action is when the authorities order the write-down of principal or transfer a nondeferrable subordinated instrument to a different legal entity from that carrying the senior debt, but also provide protection for the senior creditors. Such flexibility may form part of legislation, or be indicated by previous regulatory actions or the statements of those authorities.

59. In some jurisdictions, the authorities may have power to force a default of nondeferrable subordinated debt to protect senior creditors, as described in the previous paragraph, but use of this option in that jurisdiction is uncertain. In rare circumstances, a government may indicate its intention to prevent losses on nondeferrable subordinated debt. The rating methodology in such a situation is to notch down from the ICR instead of from the SACP.

60. If regulatory actions support a bank's senior debt, but allow a default on nondeferrable subordinated debt, the affected subordinated debt instrument receives a rating of 'D' on its default.

61. For nondeferrable subordinated debt of a banking subsidiary of an operating bank parent, or nondeferrable subordinated debt of an NOHC, the criteria in paragraphs 29-31 also apply.

## C. Criteria common to banks and nonbank financial services issues

### C.1. Rating The Issue: Default And Distress

62. The issue credit ratings on hybrid capital instruments, or on any debt instrument with a coupon deferral or cancellation feature or principal write-down or deferral feature, are generally lowered to 'D' when payments are deferred or reduced on a permanent basis according to terms of the instrument. This includes: nonpayment of interest or dividends on a non-cumulative instrument (where missed coupons are not repaid in the future); write-down of principal; or conversion to common equity due to a credit event. Here "coupon" refers to periodic distributions, regardless of how they are described under the terms and conditions of the instrument (including such descriptions as "coupons," "interest," or "dividends"). The issue credit ratings on hybrid capital instruments with cumulative deferral provisions (such as cumulative preferred stock), or economically equivalent structures that also allow temporary coupon deferral without interest on deferred interest, will be lowered to 'D' upon deferral. The exception is if we expect that the deferral period: a) will be short term, typically one year or less, and b) will be in accordance with the terms of the instrument.

### C.2. Rating The Issue: Government Support

63. Our criteria for rating the hybrid capital securities of government-related entities (GRE) deserve particular mention. When TRC expects the government to support a GRE's debt obligations but has less confidence that the support would be extended to the entity's hybrid capital instruments , then the base off which we apply notching to rate the hybrid capital instrument may not only be the ICR (which factors in our expectations of extraordinary potential government support). The issuer's SACP (which excludes our expectations of extraordinary potential government support) is also a relevant rating factor in these situations.
64. Our approach would be similar in the case of an entity on which the assigned ICR factored in our expectations of extraordinary potential group support, but where we doubted whether group support would be extended to the subsidiary's hybrid capital instruments.

These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as TRC's assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.

## Related Criteria


- Understanding Taiwan Ratings' Rating Definitions, www.taiwanratings.com – June 26, 2018
- Methodology For National And Regional Scale Credit Ratings- June 25, 2018
- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Principles For Rating Debt Issues Based On Imputed Promises - December 19, 2014
- Methodology: Use Of 'C' And 'D' Issue Credit Ratings For Hybrid Capital And Payment-In-Kind Instruments - October 24, 2013
- Hybrid Capital Handbook: September 2008 Edition - September 15, 2008

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