



## ICRA Rating Criteria for New Capital Instruments

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*With the Reserve Bank of India (RBI) issuing guidelines for the raising of capital by Indian Scheduled Commercial Banks (SCBs) via new instruments, the scope for growth is now wider for the SCBs. The guidelines permit the use of innovative capital instruments for inclusion in Tier I (referred to as Lower Tier I in this note) and hybrid debt instruments for inclusion in Tier II (referred to as Upper Tier II in this note). However, even as the equity-like characteristics of these new instruments make them eligible for inclusion in capital thereby offering significant expansion space, it is these very features that carry the potential to impact two key credit rating drivers: probability of default, and loss given default<sup>1</sup>. This note presents ICRA's assessment of how the special features of the new capital instruments can impact the two key drivers and hence the credit ratings of the new instruments. Going forward, the list of capital instruments that SCBs may use to reinforce their capital base is likely to be enlarged further. ICRA would evaluate the relevant features of such instruments on similar lines as and when the RBI issues guidelines for same*

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<sup>1</sup> More relevant in the case of non-investment grade ratings

Prior to the January 2006 announcement of guidelines by the RBI on the use of new instruments for capital raising by banks, apart from internal generation, the only options available to Indian SCBs to shore up their capital were equity issues and subordinated debt. However, the Basel Accord offered a wider scope to banks seeking to reinforce their capital base (refer Table 1).

**Table 1: Constituents of Banks' Tier I and Tier II Capital under Basel Accord**

Tier I Capital	<ul style="list-style-type: none"> <li>• Permanent shareholders equity</li> <li>• Perpetual non-cumulative preference shares</li> <li>• Disclosed reserves</li> <li>• Innovative capital instruments</li> </ul>
Tier II Capital	<ul style="list-style-type: none"> <li>• Undisclosed reserves</li> <li>• Revaluation reserves</li> <li>• General provisions and loan loss reserves</li> <li>• Hybrid capital instruments</li> <li>• Subordinated debt</li> </ul>

The confinement of capital raising options to equity and subordinated debt, besides internal capital generation, could have been a limiting factor, especially for public sector banks<sup>2</sup> (PSBs) and even for the rapidly-growing private banks. Anticipating this likely scenario, the RBI has, in line with the [Basel II](#) guidelines and international experience, introduced certain regulatory changes in 2005-06 so as to provide greater latitude to Indian SCBs to reinforce their capital base. One of the major changes is the January 2006 announcement of detailed guidelines for the raising of capital via the following capital instruments:

- ◆ Innovative capital instruments for inclusion in Tier I (referred to as Lower Tier I in this note)
- ◆ Hybrid debt instruments for inclusion in Tier II (referred to as Upper Tier II in this note)

*Please refer Annexure for a comparison of these instruments' features that influence their credit profile.*

The recent regulatory changes provide more flexibility to SCBs to achieve higher Tier I, besides offering significantly greater latitude for the raising of Tier II capital. ([Refer ICRA's note Introduction of new capital instruments by RBI for more details on the same.](#)) Going forward, the RBI may come out with detailed guidelines on raising of preference capital and Tier III capital, which could further enhance the capital-raising options for SCBs.

## New Instruments: Credit Rating Criteria

The key parameters on which the new capital instruments differ significantly from the older ones, from the point of view of impact on probability of default and loss given default, are:

1. Lock-in clause (right to defer payments and nature of interest)
2. Superiority of claims
3. Maturity profile

A comparison between the new instruments and the Old Tier II on these parameters and the rating implications of the differences are presented in the section after this. Currently, ICRA does not make a rating distinction between the Old Tier II and the Senior Unsecured Debt of banks on account of the following reasons:

- Old Tier II instruments are free from the deferral clauses on debt servicing, i.e. even if the capital adequacy is below the regulatory minimum or losses have been incurred, banks do not face any constraint in servicing the conventional instruments. In India and most other markets, banks are observed to have greater willingness to avoid defaults (in most cases systemic support is also extended by sovereign authorities) to avoid reputation risk (or even systemic instability).
- There is not much of a difference in the superiority of claims between Senior Unsecured Debt and Old Tier II.
- Old Tier II issuances are mostly of shorter term maturity (usually 10 years).

<sup>2</sup> for them, the scope to raise capital via equity issue is limited by the fact that Government's holding in the PSBs is already close to 51%

## Key Differentiating Factors: Rating Implications

### ▪ Lock-in Clause (Right to Defer Payments and Nature of Interest)

**Table 2: Comparison among Instruments on the Parameter of Lock-in Clause**

	Lower Tier I	Upper Tier II	Old Tier II
Right to defer payments	<ul style="list-style-type: none"> <li>• Issuer not liable to pay interest if capital to risk weighted assets ratio (CRAR) falls/likely to fall below minimum regulatory requirement.</li> <li>• Can be paid, subject to RBI approval, in a loss situation provided the regulatory condition on CRAR is met. Interest cannot be accumulated.</li> </ul>	<ul style="list-style-type: none"> <li>• Issuer not liable to pay either interest or principal if CRAR falls/likely to fall below minimum regulatory requirement.</li> <li>• However, debt servicing possible, subject to RBI approval, in a loss situation provided the regulatory condition on CRAR is met. Interest can be accumulated and can be paid once the conditions are met.</li> </ul>	No such restriction
Nature of interest	<ul style="list-style-type: none"> <li>• Non-cumulative interest</li> </ul>	<ul style="list-style-type: none"> <li>• Cumulative interest</li> </ul>	<ul style="list-style-type: none"> <li>• Not determined by the RBI</li> </ul>

### Rating Implication

**Right to defer payments:** Although deferral is allowed according to the terms of the issue, non-payment would mean economic loss to investor/s and would therefore be construed as default by ICRA. This practice is in line with that followed by international rating agencies.

Further, besides the traditional default triggers<sup>3</sup>, the new capital instruments have an additional trigger, which is, decline of capital adequacy below the regulatory minimum of 9%. The new trigger arises from the restrictions imposed by the lock-in clause. The probability of default on the new capital instruments therefore is likely to be higher than that on the traditional ones. Thus, even though the regulatory norm on CRAR was breached by some banks in the past (see Table 3), there was no instance of default on their traditional debt. Such however would not have been the case with the new capital instruments, and the capital adequacy linked deferral trigger would have led to default.

**Table 3: Capital Adequacy going below Regulatory Norm—Some Instances**

	Mar-96	Mar-97	Mar-98	Mar-99	Mar-00	Mar-01	Mar-02	Mar-03	Mar-04	Mar-05
Dena Bank	8.27	10.81	11.88	11.14	11.63	<b>7.73</b>	<b>7.64</b>	<b>6.02</b>	9.48	11.91
Indian Bank	<b>Negative</b>	<b>Negative</b>	<b>1.41</b>	<b>Negative</b>	<b>Negative</b>	<b>Negative</b>	<b>1.7</b>	10.85	12.82	14.14
UCO Bank	<b>7.83</b>	<b>3.16</b>	9.07	9.63	9.15	9.05	9.64	10.04	11.88	11.26
Catholic Syrian Bank	<b>2.25</b>	<b>2.51</b>	<b>3.04</b>	<b>6.06</b>	<b>5.94</b>	<b>6.08</b>	9.57	10.58	11.23	11.35
Andhra Bank	<b>5.07</b>	12.05	12.37	11.02	13.36	13.4	12.59	13.62	13.71	12.11
Indian Overseas Bank	<b>5.95</b>	10.07	9.34	10.15	9.15	10.24	10.82	11.3	12.49	14.2
Punjab & Sindh Bank	<b>3.31</b>	9.23	11.39	10.94	11.57	11.42	10.7	10.43	11.06	9.46
United Bank of India	<b>3.5</b>	8.23	8.41	9.6	9.6	10.4	12.02	15.17	17.04	18.16

In assessing the likelihood of the capital adequacy-trigger prompting default, ICRA does not take a view on the issuer's ability to raise fresh capital and thereby honour its debt commitments against relatively longer-term capital instruments (minimum 15 years). Moreover, the ability of an issuer to raise capital in the long run is always difficult to estimate in a stress situation, given that there could be impeding circumstances, internal or external or both, beyond the control of the issuer.

<sup>3</sup> such as, loss on account of asset quality impairment or mark-to-market losses, inability to refinance, or asset-liability mismatch.

In the light of the higher probability of default on the new capital instruments, ICRA would notch down the credit ratings of both Lower Tier I and Upper Tier II from the level assigned to Old Tier II, which does not have any capital adequacy-linked default triggers. This would be in line with the policy followed by international rating agencies (Moody's Investors Service, Standard & Poor's, and Fitch), which treat Subordinated Debt the same way.

Nature of interest: Further, although the loss given default in the case of Lower Tier 1 is likely to be higher<sup>4</sup> versus Upper Tier II because of the differences in the nature of interest, ICRA does not propose to make any rating distinction between the two, provided the issuer is in the investment grade. This is so since ICRA's investment grade ratings primarily reflect the probability of default and not loss given default. However, ratings in the non-investment grade could be notched down, as in this category, both the probability of default and loss given default have a bearing on the credit rating.

### ▪ Superiority of Claims

**Table 4: Comparison among Instruments on the Parameter of Superiority of Claims**

	Lower Tier I	Upper Tier II	Old Tier II
Superiority of Claims	Superior to claims of investors in equity shares	Superior to claims of investors in equity shares and investors in instruments eligible for Tier I	Superior to claims of investors in equity shares and investors in instruments eligible for Tier I and Upper Tier II

#### Rating Implication

Superiority of claims makes the loss absorption capacity offered by new instruments relatively higher compared to the traditional subordinated debt. This could make the probability of default higher for Lower Tier I vis-à-vis Upper Tier II (higher than Old Tier II for both). However, the clause would have credit implications primarily at the stage of liquidation—a relatively low possibility for higher-rated issuers. Therefore, although Lower Tier I is inferior to Upper Tier II in the priority of claims, given that the probability of liquidation is rather remote for better-rated issuers, this feature may not lead to notching of Lower Tier I to below Upper Tier II for the higher rating categories. However, for issuers in the lower rating categories, Lower Tier I may be notched to below Upper Tier II.

### ▪ Maturity Profile

**Table 5: Comparison among Instruments on the Parameter of Maturity Profile**

	Lower Tier I	Upper Tier II	Old Tier II
Maturity	Perpetual	More than 15 years	Minimum five years
Options allowed	Call Option after 10 years, subject to RBI approval	Call Option after 10 years, subject to RBI approval	No such option allowed

#### Rating Implication

- ◆ As both Lower Tier I and Upper Tier II are of fairly long maturity with similar call options (to be exercised with the RBI's approval), ICRA treats them at par for the purpose of credit risk rating.
- ◆ As for the call option, it is a right vested with the issuer (and not an obligation), which can be exercised only with the RBI's approval. The option therefore cannot be exercised in a stress situation, which could have impacted the probability of default thereby calling for a rating differentiation from subordinated debt (old Tier II).

<sup>4</sup> on account of the non-cumulative nature of interest, as any missed interest repayment would be tantamount to permanent loss to the investor. In the case of Upper Tier II however, the interest can be accumulated and it is therefore subject to potentially lower losses.

## Conclusion

The provisions of the new RBI guidelines prohibit SCBs from servicing the new instruments in breach of regulatory capital adequacy. This implies relatively greater uncertainty and thus higher probability of default (than conventional instruments), which ICRA would communicate via notched-down ratings of new instruments. This policy is in line with the practice followed by international rating agencies. While in ICRA's view, no clause contained in the RBI guidelines necessitates rating differentiation between Lower Tier I and Upper Tier II for stronger banks, that is not the case with banks that have relatively weak credit profiles. For the latter class, the clauses on nature of interest and superiority of claims may well warrant a notching-down of Lower Tier 1 to below Upper Tier II. This however would be decided by ICRA's Rating Committee on a case-to-case basis.

## Annexure

	Lower Tier 1	Upper Tier 2	Old Tier 2
Right to defer payments	<p>(a) Innovative instruments, shall be subjected to a lock-in clause in terms of which the issuing bank shall not be liable to pay interest, if</p> <ol style="list-style-type: none"> <li>1. the bank's CRAR is below the minimum regulatory requirement prescribed by the RBI;</li> </ol> <p style="text-align: right;">OR</p> <ol style="list-style-type: none"> <li>2. the impact of such payment results in the bank's CRAR falling below or remaining below the minimum regulatory requirement prescribed by the RBI.</li> </ol> <p>(b) However, banks may pay interest with the prior approval of the RBI when the impact of such payment may result in net loss or increase the net loss, provided the CRAR remains above the regulatory norm.</p> <p>(c) The interest shall not be cumulative.</p>	<p>(a) Upper Tier 2 instruments shall be subjected to a lock-in clause in terms of which the issuing bank shall not be liable to pay either interest or principal, even at maturity, if</p> <ol style="list-style-type: none"> <li>1. the bank's CRAR is below the minimum regulatory requirement prescribed by the RBI</li> </ol> <p style="text-align: center;">OR</p> <ol style="list-style-type: none"> <li>2. the impact of such payment results in bank's CRAR falling below or remaining below the minimum regulatory requirement prescribed by the RBI.</li> </ol> <p>(b) However, banks may pay interest with the prior approval of the RBI when the impact of such payment may result in net loss or increase the net loss provided the CRAR remains above the regulatory norm.</p> <p>(c) The interest amount due and remaining unpaid may be allowed to be paid the later years in cash/cheque, subject to the bank complying with the above regulatory requirement.</p>	No such restriction
Redemption		Upper Tier 2 instruments shall not be redeemable at the initiative of the holder. All redemption shall be made only with the prior approval of the RBI.	
Step-up option	The issuing bank may have a step-up option, which may be exercised only once during the life of the instrument, in conjunction with the call option, after the lapse of 10 years from the date of issue. The step-up shall not exceed 100 basis points. The limits on step-up apply to the all-in cost of the debt to the issuing banks.	The issuing bank may have a step-up option, which may be exercised only once during the life of the instrument, in conjunction with the call option, after the lapse of 10 years from the date of issue. The step-up shall not exceed 100 basis points. The limits on step-up apply to the all-in cost of the debt to the issuing banks.	No such option

cont...

	<b>Lower Tier 1</b>	<b>Upper Tier 2</b>	<b>Old Tier 2</b>
Superiority of claims	Superior to claims of investors in equity shares	Superior to claims of investors in equity shares and investors in instruments eligible for Tier 1	According to the existing instruments possible for Indian Banks superior to equity, innovative Tier 1 and Upper Tier 2
Maturity	<ul style="list-style-type: none"> <li>◆ Perpetual</li> <li>◆ Call Option after 10 years, subject to the RBI's approval. While considering the proposals received from banks for exercising the call option, the RBI would, among other things, take into consideration the banks' CRAR position both at the time of exercise of the call option and after it.</li> </ul>	<ul style="list-style-type: none"> <li>◆ Minimum 15 years</li> <li>◆ Call option after 10 years, subject to the RBI's approval. While considering the proposals received from banks for exercising the call option, the RBI would, among other things, take into consideration the banks' CRAR position both at the time of exercise of the call option and after.</li> </ul>	<ul style="list-style-type: none"> <li>◆ Minimum maturity five years</li> <li>◆ No such option allowed</li> </ul>



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