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ARCHIVED: TRC Financial Services Issue Credit Rating Criteria

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(Editor's Note: This article is no longer current and has been superseded by "National And Regional Scale Credit Ratings Methodology" published on June 8, 2023.)

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OVERVIEW AND SCOPE

1. Taiwan Ratings Corp. (TRC) is refining its issue credit rating criteria to provide guidelines on the issue credit rating of financial services sectors). This article is related to S&P Global Ratings' criteria articles "Hybrid Capital: Methodology And Assumptions," published March 2, 2022 and "Methodology For National And Regional Scale Credit Ratings," published on June 25, 2018.

SCOPE OF THE CRITERIA

2. The criteria establish our framework for defining a hybrid that falls under these criteria and assigning a hybrid capital instrument rating (and Conventional Nondeferrable Subordinated Debt [NDSD] issued by Banks).

3. Hybrid capital generally refers to an instrument that has characteristics of both debt and equity, and therefore excludes common equity. Taiwan Ratings considers an instrument to be a hybrid capital instrument if, and only if, without causing a legal default or liquidation of the issuer, it can absorb losses or conserve cash. Examples of such loss absorption or cash conservation include:

- Deferral of the coupon;
- Write-down of principal; or
- Conversion into common equity or another hybrid capital instrument.

4. This applies to all hybrid instruments issued by corporate, financial institution, and insurance entities. It also applies to conventional NDSD issued by banks.

KEY PUBLICATION INFORMATION

- Effective date: July 31, 2019
- These criteria address the fundamentals set out in "Principles Of Credit Ratings," published on Feb. 17, 2011

METHODOLOGY

5. These criteria provide our methodology for rating hybrid capital instruments of financial service sector on TRC rating scale.

Assigning An Issue Credit Rating To A Hybrid Instrument

General Principles

6. For instruments that are ratable, we assign an issue credit rating by notching down from the starting point for that issuer. Notching for hybrid instruments generally combines: 1) one or two notches for subordination and 2) one or more notches to reflect the risk of loss absorption or cash conservation. This applies to all hybrids.

7. Through paragraphs 13 to 40, notching is applied in the following way:

   First, we establish on the global scale the rating level that reflects the instrument's default risk and apply related notching.

   Second, we use this rating level on the global scale to map to the indicative TRC scale rating.

   Third, we apply incremental notches down from the indicative TRC scale rating for subordination.

   Lastly, in some cases we cap the global scale hybrid capital instrument's issue credit rating at 'CCC', in which case the TRC scale credit rating would be capped at the correlation related to 'CCC'.

8. We do not rate an instrument if it has a loss-absorption or cash conservation trigger that is not related to the issuer's creditworthiness, in line with our criteria "Principles For Rating Debt Issues Based On Imputed Promises". Examples of such triggers include those linked to an issuer's market capitalization or share price. Others include those based on regulators' concerns about financial stability in the broader market, or linked to events or situations that cannot be observed using public information, for example, where a regulator has full discretion to activate the trigger while an issuer is still a going concern. However, if the regulator's discretion extends only to deciding whether an issuer is about to breach a defined and observable regulatory ratio, or only to deciding whether an issuer is nonviable, then the instrument is a nonviability contingent capital (NVCC) instrument, and is ratable.

9. A debt instrument that transforms into a hybrid instrument upon a trigger event will be rated based on its hybrid features if we anticipate that the trigger will be activated at or before loss absorption or cash conservation on an equivalent hybrid instrument.

10. We rate MCSs and Equity Units (whether matched or mismatched) based on the features in the hybrid documentation before the conversion of the security.

11. If a hybrid instrument has a guarantee from a higher-rated entity, then we apply our criteria "Guarantee Criteria."

12. We apply this criteria to banks, insurers, financial services finance companies that are prudentially regulated, certain financial market infrastructure companies, NBFI finance companies, NBFI securities firms, and financial holding companies.

Starting point for notching in insurance entities

13. For insurance entities (including insurance NOHCs) we generally assign an issue credit rating to a hybrid capital instrument by notching down from the ICR on the issuer. That said, we exclude any elements of support that we do not expect to apply to the hybrid from our starting point. For example, if the ICR includes uplift for potential extraordinary group, government, or additional loss-absorbing capacity (ALAC) support that we do not expect to apply to the hybrid, we typically exclude those elements of

potential support from the starting point for notching. For example, we may notch down from the SACP in certain cases instead.

Notching for subordination

14. For hybrids and NDSD issued by banks and hybrids issued by insurance entities (including NOHCs), where the applicable starting point for notching is 'twbbb-' or 'twBBB-' or higher, we deduct one notch for subordination. Otherwise, we deduct two notches for subordination.
15. When a holding company issues debt, as is common in Taiwan, the notching is relative to our ICR on the holding company, which is typically lower than the ICR on the main operating unit.
16. We do not deduct additional notches for different degrees of subordination in any sector.

Notching for risk of loss absorption or cash conservation

17. We reflect the risk of loss absorption or cash conservation, either of which create payment risk, by deducting one or more notches.
18. Instruments issued by prudentially regulated entities that have a mandatory contingent capital clause based on a nonviability trigger are rated one notch lower than an equivalent hybrid instrument that does not have such a feature, unless the clause is only activated after the issuer's share capital has been depleted to zero.
19. If we consider that the payment risk (that is, the likelihood of loss absorption or cash conservation) for a specific instrument is not reflected in either the starting point or the minimum notching, we apply wider notching at issuance. We may also revise the notching as part of our surveillance if the payment risk increases or decreases over the life of the instrument. We do not impose a limit on the number of notches that we may deduct for payment risk.
20. If the instrument includes features that enable the issuer to modify it in such a way that the risk of loss absorption or cash conservation would increase, we incorporate those features into the rating from the issue date. Where an external event must occur before an issuer may modify the instrument, we do not typically incorporate the potential change in the terms of the instrument into the rating.
21. Payment-In-Kind (PIK) Instruments (including Toggle Notes) are typically not subject to notching for the risk of loss absorption or cash conservation, as the imputed promise will not generally be breached before the instrument's maturity date. However, if a PIK instrument's terms and conditions create an imputed promise that the investor will receive payments in cash during the instrument's life (and these payments can be deferred), we typically treat the feature as equivalent to cumulative coupon deferability and notch as if the instrument contained such a deferability feature.
22. We cap at 'CCC' global scale rating, in which case the TRC scale credit rating would be capped at the correlation related to ‘CCC’, on a hybrid instrument that has a contingent capital trigger leading to common equity conversion or principal write-down, or both, that is based on a specified rating change. Note that we do not consider a contingent capital trigger to be based on a rating change if it is based on an entity entering into bankruptcy or similar proceedings.
23. We apply "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings," published Oct. 1, 2012, where the risk of loss absorption or cash conservation exceeds a 'B-' scenario. We first determine the likelihood of the instrument defaulting, and then adjust for subordination where relevant, subject to a floor at 'twC' for subordinated instruments and at 'twCC' for unsubordinated instruments. The rating goes to 'D' (default) in the situations described in table 1.

Table 1

Rating Hybrids At 'D' (Default)

Form Of Loss Absorption Or Cash Conservation	Issue Credit Rating
Permanent	
Noncumulative coupon deferral	'D'
Principal write-down	'D'
Trigger-based conversion to common equity	'D' unless investor receives original value of promise
Distressed restructuring	'D'
Temporary	
Cumulative coupon deferral (with or without compound interest)	'D' unless we expect the investor to receive the full coupon amount (including compound interest where applicable) within a year
Principal deferral in accordance with terms and conditions	'D' unless we expect the full principal amount to be paid within a year with no permanent diminished interest payment to the investor
PIK: Exercise of PIK option on an instrument rated on a imputed promise that the investor will receive payments in cash	'D' unless we expect the investor to receive the full PIK amount (including any compound interest) within a year

PIK--Payment in kind. Copyright © by Taiwan Ratings Corp. All rights reserved.

Rating The Hybrid Instrument: Additional Considerations For Banks

24. The criteria in this section apply to all ratable bank hybrid instruments, regardless of their equity content classification or whether they are considered part of regulatory capital. This section also applies to certain nonbank financial institution (NBFI) subsectors, and also gives the approach for rating bank conventional nondeferrable subordinated debt instruments that are not classified as hybrids.

25. To assign a rating to a bank hybrid capital instrument, we deduct notches from our starting point.

26. The sum of the total number of notches deducted in each step is deducted from the starting point to arrive at the issue credit rating on the hybrid (see table 2).

Table 2

Rating Bank And Bank Nonoperating Holding Company (NOHC) Hybrid Capital Instruments

Instrument features	Number of notches
Step 1: Standard notching	
Step 1a: If the instrument has a discretionary or mandatory deferral clause that would lead to coupon deferral and the regulator classifies it as regulatory capital, deduct notches. This applies even if coupon deferral can only occur when a bank breaches its minimum regulatory capital requirements (see further details below).	For a regulatory Tier 1 instrument in a jurisdiction that has adopted or is planning to adopt the general provisions of Basel III or equivalent measures, deduct two notches. Otherwise, deduct one notch.
Step 1b: Whenever an instrument is subordinated to senior unsecured debt in resolution or liquidation, regardless of its labeling, deduct notches to reflect contractual subordination. Notching does not vary for different subcategories of contractual subordination.	One notch where the starting point of subordination is 'twbbb-' or above; otherwise two notches.
Step 1c: Identify whether the instrument has a mandatory contingent capital clause leading to common-equity conversion or a principal write-down, or both; or whether the relevant regulatory or legal framework creates the equivalent of such a clause.	Deduct one notch, in line with paragraphs 18, 33, and 34.

Step 2: Additional notching

Step 2a: If the instrument has a mandatory going-concern trigger (either statutory or contractual) linked to a regulatory capital ratio in the form of a specific number, deduct notches as specified to factor in the difference between our expectations of a bank's regulatory ratios and the regulatory ratio level that triggers the loss absorption or cash conservation. Step 2a and Step 1c both apply for such an instrument.	If so, deduct additional notches or apply rating caps, as follows, when we expect the regulatory capital ratio to stay within a given range of the trigger or at a minimum level:
	--If 301bps-700bps: deduct one notch;
	--If 201bps-300bps: deduct two notches;
	--If 101bps-200bps: deduct four notches; or
	--If up to 100bps: deduct four notches and set the issue credit rating no higher than at the correlation related to a 'CCC' global scale rating.
Step 2b: Identify whether the instrument has loss absorption or cash conservation risks that neither our assessment of the starting point nor the standard notching in Steps 1a to 1c and Step 2a fully captures.	If so, deduct one, two, or three additional notches, depending on the likelihood of nonpayment on the instrument.
Step 2c: Identify whether the instrument has a contingent capital clause based on a rating change trigger that leads to common-equity conversion or a principal write-down, or both.	Refer to paragraph 22.

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Starting point for standard notching

27. We assign a rating to an operating bank's hybrid capital instrument by notching down from the bank's SACP, except in the following situations, when the starting point is the ICR:

- If the bank is a subsidiary that is core, highly strategic, or strategically important, and we expect group support to be applied to the subsidiary's hybrids such that the hybrid would not absorb losses;
- If the bank is a government-related entity, the likelihood of government support under our criteria "Rating Government-Related Entities: Methodology And Assumptions" published on March 25, 2015, is almost certain, extremely high, or very high; and we consider that financial support from the government would result in the hybrid not absorbing losses or conserving cash; or
- If the ICR on a bank is lower than the SACP.

28. Where the hybrid instrument is issued by an NOHC, the starting point is typically the lower of the ICR and the GCP or group SACP that applies to the group or subgroup headed by the NOHC.

29. If, however, the ICR of the operating entity is the starting point for an equivalent hybrid issued by the operating entity, and we expect that external support will apply to the NOHC hybrid capital instrument, we use the GCP as the starting point for the NOHC hybrid.

Standard Notching

30. For all bank hybrid capital instruments, our notching methodology starts with standard notching, which is the sum of:

- Step 1a: For the risk of a partial or untimely payment; and
- Step 1b: Notching for contractual subordination;

- Step 1c: Where applicable, for a mandatory contingent capital clause leading to conversion into common equity, a principal write-down, or both.

31. Further details on Step 1a: We deduct one notch in the following cases:

- A Tier 1 instrument that is not subject to Basel III;
- A Tier 2 instrument that has a deferrable coupon;
- A legacy Tier 1 instrument that is not subject to the general provisions of Basel III (or equivalent rules) or where the issuer is not in a jurisdiction that plans to adopt Basel III or any equivalent measures;
- A deferrable instrument issued by a company that is not subject to Tier 1 or Tier 2 regulatory capital classifications; or
- A hybrid instrument that has restrictions preventing coupon nonpayment.

32. We deduct two notches in the following cases:

- A regulatory Tier 1 instrument issued by a bank that is subject to, or in a jurisdiction that plans to adopt, the general provisions of Basel III or equivalent rules;
- A legacy Tier 1 instrument that is now subject to Basel III or equivalent rules;
- A Tier 2 or other hybrid instrument for which coupon deferral risk is linked to a Tier 1 instrument; or
- A hybrid instrument for which Basel III provisions apply or will be adopted, even if it has a restricted ability to defer coupon payments.

33. Further details on Step 1c: We deduct one notch for going concern or NVCC clauses unless:

- We anticipate that the regulatory environment is such that the bank is likely to receive pre-emptive extraordinary government support if it is in distress, at a relatively early stage of its deterioration; and
- The regulator's statements suggest that such pre-emptive government support would not constitute a nonviability event and would therefore not lead to a principal write-down or equity conversion of the hybrid.

34. We would not typically deduct a notch for Tier 3 or similar instruments that are only subject to write-down or conversion in a resolution.

Additional Notching

35. Additional notching is applied to address the following risks:

- Step 2a: The instrument has a statutory or contractual mandatory going-concern trigger that is linked to a specific regulatory capital ratio, expressed as a number.
- Step 2b: Loss absorption or cash conservation risks that are not captured elsewhere in our assessment.
- Step 2c: Contingent capital clauses based on a rating change.

36. Further details on Step 2a: We deduct further notches in line with the capital ratio ranges shown under Step 2a in table 3 if the trigger results in deferral of coupons, or is a contingent capital trigger that leads to a principal write-down or conversion into common equity.

37. In these cases, the deduction reflects the difference between our expectations of a bank's regulatory ratios and the regulatory ratio level that triggers the loss absorption or cash conservation, based on the lowest regulatory capital ratio we expect for the subsequent 12-24 months, or a higher capital ratio if we strongly expect that capital will strengthen imminently in response to actions the bank has announced.

38. We consider a trigger that relates to compliance with a minimum regulatory capital requirement to maintain a banking license to be a nonviability trigger, in which case Step 2a does not apply.

39. Further details on Step 2b: We deduct up to three notches for loss-absorption risks that the standard notching and Step 2a do not capture, depending on the likelihood of loss absorption on the instrument.

40. We cap our rating on a hybrid issued by a bank subsidiary of an operating bank at the level we would rate an otherwise identical hybrid issued by the parent bank (even if no such hybrid has been issued). We would not cap the rating at the level of the rating on an otherwise identical hybrid issued by an NOHC in the banking group. We also do not cap the rating on the subsidiary's hybrid if the ICR on the subsidiary is higher than that on the parent bank.

Nondeferrable subordinated bank debt

41. We classify NDSD as hybrids, and rate it using the steps outlined in table 2 (including the relevant starting points) if the instrument:

- Has a contractual or statutory mandatory contingent capital feature that enables it to absorb losses before a legal default of the issuer; or
- Constitutes part of a bank's regulatory capital and has a higher default risk than the bank's senior debt due to a discretionary contractual or statutory contingent capital feature or resolution regime arrangements.

42. Conventional bank NDSD is not classified as a hybrid so, if a bank ICR is 'twBBB-' or higher, we rate its conventional NDSD one notch below the ICR; where the ICR is 'twBB+' or lower, the issue credit rating is two notches below the ICR, subject to a floor at 'twC', unless 'D' applies.

Glossary

Please refer to the Glossary of 'Hybrid Capital: Methodology And Assumptions – July 1, 2019'.

Impact On Outstanding Ratings

This criteria revision does not result in rating actions on current outstanding debt and hybrid issues.

RELATED PUBLICATIONS

Related criteria

- Hybrid Capital: Methodology And Assumptions – March 2, 2022
- Methodology For National And Regional Scale Credit Ratings- June 25, 2018

Related guidance

- Guidance: Hybrid Capital: Methodology And Assumptions - July 1, 2019
- Taiwan Ratings' Ratings Definitions – Nov. 11, 2021

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