Methodology Basel III Compliant Debt Instrument Rating

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Summary

This methodology describes PACRA's approach to rating Basel III Compliant debt instruments. To arrive at the rating, PACRA first forms an opinion on the issuing bank, as per its Rating Methodology for Banks which is used as a baseline. PACRA then goes on to incorporate the unique characteristics of the instrument being rated into its analysis. The methodology highlights the salient criteria of Tier I and Tier II debt instruments that are considered crucial while forming a view on the rating.

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0. Introduction

- Debt instrument market
- Key types of debt instruments

Introduction

0.1 Debt instrument market: Pakistan has a relatively small debt instrument market. Financing through bank loans is the preferred route for corporates, rather than utilizing capital markets to raise funding through issuing debt instruments like bonds. Therefore, when instruments are issued, they are plain-vanilla and secured by the assets of the company. Retail investors have also been tapped but generally the instruments are the domain of institutional investors – banks, mutual funds, and retirement benefit schemes. Instrument denominations and tenor also remain on the lower side. Given relatively small base and held to maturity stance of most investors, secondary market is yet to evolve in a meaningful platform.

0.2 Key Types of Debt Instruments: Key types of debt instruments are: term finance certificates (TFCs), commercial papers and Sukuk. These can be differentiated on the basis of: (i) maturity (money market vs. capital market debt instruments), (ii) issuing entities (government, financial institutions, corporates, etc.), (iii) markets in which they are issued (conventional vs. Islamic), (iv) accessibility (listed vs. privately-placed), and (v) security (secured, unsecured or subordinated). PACRA has evolved separate methodologies to cater to the distinct features of structured debt instruments, Sukuk, Basel III Compliant debt instruments and preference shares.

Debt instruments	• Securities with underlying contractual obligation owed by the issuer to make interest payments and principal repayments to the debt instrument holders (or “lenders”) for the life of the debt instrument.
Structured debt instruments	• Debt instruments designed to cater to complex financing needs through securitization.
Sukuk	• Islamic debt instruments also referred to as "Shariah-compliant bonds".
Basel III Compliant Debt Instruments	• Debt instruments issued by banks to enhance capital adequacy, based on regulatory requirement prescribed by the State Bank of Pakistan.
Preference Shares	• Hybrid instruments sharing both debt and equity characteristics, with fixed-rate dividend and principal redemption agreement.

0.3 Basel III (BPRD 06 of 2013) stipulates two main categories of capital: (1) Tier 1 (going concern capital), and (2) Tier 2 (gone concern capital). Tier 1 capital further consists of (i) Common Equity Tier 1 and (ii) Additional Tier 1. For the purpose of debt instrument, we are concerned with Additional Tier 1 (ADT1) and Tier 2 (T2) debt instruments. The BPRD 06 has given a detailed criteria that debt instruments have to fulfil to qualify as ADT1 or T2 debt instruments (Annexure I & II).

0.4 The purpose of a subordinate debt instrument issued by a bank is to enhance its capital adequacy. A bank may issue Tier-I instrument or Tier-II instrument to boost its Additional Tier I or Tier II ratio respectively. Traditionally, domestic banks in Pakistan have been issuing Tier II instruments. Lately, banks have shown keen interest in issuing Tier I instrument under Basel III regime. This is expected to gain momentum given related advantages. PACRA evaluates both risks differently depending upon the structure of the issued instrument and its purpose.

1. Rating Approach

- Tier 2
- Tier 1

Rating Approach

1.1 PACRA's debt instrument credit rating is an assessment of a specific debt issue of a bank and provides: (i) an opinion on the issuing bank's ability to meet on a timely basis its principal and interest obligations pertaining to the debt instrument being rated. For the purpose of the rating assessment, both interest and principal repayment are considered "contractual obligations" by PACRA. Tier 1 debt instruments are perpetual and hence repayment of principal is not a consideration. Repayment of interest is considered contractual obligation.

1.2 While forming an opinion on an issuer, PACRA follows its Bank Rating Methodology to arrive at the entity rating. In cases where PACRA does not have the mandate to rate the entity, it arrives at the shadow rating. This is then notched according to the nature of the rated instrument. PACRA is cognizant of the unique and respective criteria of T1 and T2 debt instruments. The salient criteria of T1 and T2 debt instruments that are considered crucial while forming a view on their ratings are encapsulated below:

Tier 2

- Subordinated to all other indebtedness of the bank including depositors, however, senior to the claims of investors in instruments eligible for inclusion in Tier 1 capital.
- Should have a minimum original fixed term maturity of five years.
- Should be subject to a lock-in clause, stipulating that neither interest nor principal may be paid (even at maturity) if such payments will result in shortfall in bank's MCR or CAR or increase any existing shortfall in MCR and CAR.
- Tier 2 instruments contain terms and conditions that they, at the option of the SBP, will either be fully and permanently converted into common shares or immediately written off upon the occurrence of a non-viability trigger event called the Point of Non-Viability (PONV).

Tier 1

- The instrument should rank junior to all other claims except common shares.
- Unpaid dividends/ coupons should be non-cumulative.
- The dividends/ coupons should only be paid from current year's earnings and will be subject to condition that any payment on such instruments should not result in breach of regulatory MCR and CAR requirements set by SBP from time to time.
- The issuer should have full discretion over the amount and timing of dividend/ coupon distribution i.e. the ability to waive any dividends/coupons and failure to pay should not constitute event of default.
- Instruments must have principal loss absorption through either i. Conversion to common shares at an objective pre-specified trigger point, or ii. A write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write-down would reduce the claim of the instrument in liquidation, reduce the amount to be re-paid when a call is exercised and partially or fully reduce dividend payments on the instrument.
- Tier 1 instruments are subject to loss absorption clause whereby these instruments will be permanently converted to common shares when the bank's CET1 ratio falls to or below 6.625% of RWA.
- Tier 1 instruments contain terms and conditions that they, at the option of the SBP, will either be fully and permanently converted into common shares or immediately written off upon the occurrence of a non-viability trigger event called the Point of Non-Viability (PONV).

1.3 These conditions, amongst others, clearly indicate that T2 instruments are inferior to entity rating and T1 instruments are inferior to T2 and entity rating both. This is termed "priority order" and hence forms a crucial part in determining the final rating of the rated instruments. PACRA believes that "priority order" is one critical rating factor. The other and most important rating factor is "non-performance risk". Non-performance is the risk that the issuer will not be able to meet the contractual obligations and hence other related clauses would kick in. PACRA opines non-performance is the prime risk because performance on the contractual obligations essentially mean that "priority order" would not be triggered. This is why where "non-performance" is essentially non-existent, PACRA is not strict on priority. This is particular to "AAA" (Triple A) rated institutions. Such comfort may also be available whereby PACRA is able to establish that issue specific external credit enhancement would avert "non-performance".

1.4 PACRA believes that the rating of Tier 1 and Tier 2 debt instruments is essentially based on the futuristic performance of the issuer. It is not merely a rating of the structure of the debt instruments. The bank's management and their plans would play a crucial role in the sustainability of the risk profile of the instrument. Hence PACRA considers:

- **i.** The overall credit risk profile of the bank, as captured by the entity rating.
- **ii.** Future profitability of the bank, providing internal capital and cushion to the risk absorption capacity of the bank
- **iii.** The cushion that a bank maintains in its CET1 (including capital conservation buffer) on a sustainable basis over the regulatory requirement prescribed by State Bank of Pakistan.
- **iv.** The management plan to maintain and adhere to the cushion in its CET1 ratio.

1.4.1 PACRA also takes into account entity's projections for growth vis-à-vis regulatory capital adequacy:

- **i.** Capital Adequacy Ratio (CAR) of the bank
- **ii.** Composition of the CAR including the CET-I, ADT-I and Tier-II
- **iii.** The rate of consumption of the CAR along with future forecasts.

1.5 In summary, PACRA, while rating Tier 1 and Tier 2 debt instruments, considers:

- **Non-Performance Risk**: Bank with a higher rating, typically have a history of strong equity base and steady profitability. Thereby, the risk of non-performance decreases inversely proportionate to their rating at the higher end of spectrum, thus reducing the riskiness of their instruments.
- **Priority:** PACRA takes into account the priority and level of sub-ordination and incorporate the same into rating of the respective instrument.
- **Rating Relativeness:** PACRA gives due importance to the relativeness of the ratings. An assigned rating to the instrument needs to be comparable with other similar ratings in the rating paradigm.

1.5.1 **Standardized Notching:** PACRA would be giving a minimum of one notch lower rating in case of Tier 2 instruments and a minimum of two notches lower in case of Tier 1. Exceptions to this could be:

- Exceptionally strong credit profile of the issuing bank; where there is very strong cushion available against related risks.
- Existence of issue-specific external credit enhancement.

Annexure I

Criteria for Additional Tier-1 Capital Instruments, as per Annexure II of the SBP. BPRD Circular # 6 of 2013 dated August 15, 2013.

i. The instrument is issued, fully paid-up, perpetual, unsecured and permanently available to absorb losses.

ii. The instrument should rank junior to all other claims except common shares.

iii. Dividends/ Coupons:

a. Unpaid dividends/ coupons should be non-cumulative.

b. The issuer should have full discretion over the amount and timing of dividend/ coupon distribution i.e. the ability to waive any dividends/coupons and failure to pay should not constitute event of default.

c. No compensation should be available to preference shareholders other than the dividends/ coupons.

d. The dividend/ coupon rate or formulae should be known at the time of issuance of instruments and not linked to the credit standing of the issuer.

e. The rate can be fixed or floating (with reference to any benchmark rupee rate but spreads/margin cannot be changed during the life of instrument).

f. No step-up feature in instruments should be allowed.

g. The dividends/ coupons should only be paid from current year's earnings and will be subject to condition that any payment on such instruments should not result in breach of regulatory MCR and CAR requirements set by SBP from time to time.

h. All instances of non-payment of dividends/ coupons should be notified to the Banking Policy & Regulations Department.

iv. Optionality:

a. No put option should be available to the holders of the instruments.

b. Issuer can exercise call option but after five years from issuance date with the prior approval from SBP. Bank should clearly indicate to the prospective investors that bank's right to exercise the option is subject to written approval of SBP. Banks shall not exercise a call unless they replace the called instrument with capital of same or better quality. Call premium (when issue is redeemed) is not allowed. Bank should also demonstrate that capital position is well above the minimum capital requirement after the call is exercised.

v. Redemption/ Repurchase:

a. No redemption shall be allowed in first five years of issuance. Any repayment of principle must be with the approval of SBP and bank must not create market expectation that supervisory approval will be granted.

b. There should not be any sinking fund requirements on issuer for retirements of the instrument. Further terms and conditions of the issue should not be such as to force the issuer to redeem the instruments at any point in time.

vi. Neither the bank nor a related party over which the bank exercise control or significant influence should purchase the instrument, nor should the bank directly or indirectly have funded the purchase of the instrument. Banks are not allowed to grant advances against the security of the capital instruments issued by them.

vii. The instrument should not have any features that hinder recapitalization, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.

viii. The features of instrument should be transparent, easily understood and publicly disclosed.

ix. For disclosure in the Balance Sheet, Perpetual Non-cumulative preference shares (PNCPS) will be classified as "Capital" under the heading of "Additional Tier-I" instrument subject to SBP approval, while perpetual cumulative preference shares/ perpetual debt instruments will be classified as "Liabilities" in the Balance Sheet.

x. Loss Absorption Features

a. The instrument should be able to absorb losses incurred by the issuer on a going concern and gone concern (point of non-viability) basis.
b. Instruments must have principal loss absorption through either i. Conversion to common shares at an objective pre-specified trigger point, or ii. A write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write-down would reduce the claim of the instrument in liquidation, reduce the amount to be re-paid when a call is exercised and partially or fully reduce dividend payments on the instrument.

xi. Conversion of Instruments into Ordinary Shares

a. The instruments issued by the banks may contain conversion feature based either on a price fixed at the time of issuance or pricing formula applicable at the time of conversion. However, to quantify the maximum dilution and to ensure that prior shareholder approval for any future issue of the required number of shares is held, the maximum conversion ratio based on 20 percent of the ordinary share price at the time of issue is being prescribed. Adjustments may be made for subsequent share splits, bonus issues and similar transactions.
b. In case of unlisted banks, the conversion price may be determined based on the fair value of banks" common shares which may be estimated as per mutually acceptable methodology
c. To avoid breach of any statutory ceilings, banks are required to keep all prior approvals such as sufficient room in their authorized capital for the conversion of Additional Tier-I Capital into common shares.
d. In case of convertible instruments, the conversion into ordinary shares will be allowed subject to approval of SBP and shareholders holding 5% or more of paid- up shares (ordinary or preferred) shall fulfill the fit and proper criteria of SBP.

xii. Issuance of Additional Tier 1 Capital Instruments

a. Banks interested to issue these instruments should submit terms of the issue (in the light of this annexure) for the in-principle approval of SBP. BPRD Circular # 6 of 2013 dated August 15, 2013.
b. The issuing bank should submit a report to SBP giving details of the instrument along with a copy of offering document within one month from the date of issue.
c. The proceeds of rupee denominated debt instruments offered/issued to nonresidents will have to be repatriated to Pakistan and converted into rupees by the bank concerned and the Proceeds Realization Certificate will be furnished to SBP. The bank concerned will be allowed to remit the principal amount of debt instruments at maturity as well as the profit/interest thereon from the interbank market. Hedging will not be available on such instruments. Banks should comply with all the terms and conditions, if any set out by SECP, stock exchange or under any law in the country with regard to issue of the instruments.

xiii. Bank's investment in Additional Tier 1 capital instruments issued by other banks/ financial institutions will be subject to following:

a. Attract risk weight as per Section 2.4.8 and Credit Risk/ Market Risk Chapter of SBP. BPRD Circular # 6 of 2013 dated August 15, 2013.
b. For the purpose of prudential regulation (R-6), investment in additional tier 1 capital instruments will be considered as exposure against shares.
c. Bank's investment in a single issue of such additional tier 1 capital of any other bank will not at any time exceed 15% of the total size of the issue.

Annexure II

As per SBP. BPRD Circular # 6 of 2013 dated August 15, 2013: the subordinated debt instruments (e.g. TFCs etc.) issued by banks should meet the following terms and conditions to qualify for inclusion as Tier 2 Capital for capital adequacy purposes. Subordinated debt will also include rated and listed subordinated debt instruments i.e. TFCs etc. The terms of issue for these debt instruments are as under:

i. Should be fully paid up, unsecured.

ii. Subordinated to all other indebtedness of the bank including depositors, however, senior to the claims of investors in instruments eligible for inclusion in Tier 1 capital.

iii. Should have a minimum original fixed term maturity of five years.

iv. Recognition in regulatory capital (Tier-2) in the remaining five years before maturity will be amortized on a straight line basis.

v. In case of staggered principal repayments, for inclusion as supplementary capital, the outstanding amount less any scheduled repayment must be discounted by 20% a year as indicated in the table below i.e. 20% of the original amount less any redemption) during the last five years to maturity. Remaining Maturity of Instrument Rate of Discount Less than or equal to one year 100% More than one year but less than or equal to two years 80% More than two years but less than or equal to three years 60% More than three years but less than or equal to four years 40% More than four years but less than or equal to five years 20%

Remaining Maturity of Instrument	Rate of Discount
Less than or equal to one year	100%
More than one year but less than or equal to two years	80%
More than two years but less than or equal to three years	60%
More than three years but less than or equal to four years	40%
More than four years but less than or equal to five years	20%

vi. The instruments should be rated separately by a credit rating agency recognized by SBP – Minimum rating should be equivalent to "2" as per SBP rating grid.

vii. The instruments should be "vanilla".

viii. The issuer shall decide rate of profit. The rate of profit should be known at the time of issuance of subordinated debt instruments and not linked to the credit standing of the issuer.

ix. The rate can be fixed or floating (with reference to any benchmark rupee rate), however, spreads/margin cannot be changed during the life of the instrument.

x. All instances of non-payment of profits should be notified to the Banking Policy & Regulations Department.

xi. Should not be redeemable before maturity without prior approval of SBP

xii. Should be subject to a lock-in clause, stipulating that neither interest nor principal may be paid (even at maturity) if such payments will result in shortfall in bank's MCR or CAR or increase any existing shortfall in MCR and CAR.

xiii. No put option should be allowed to investor and there should not be any step-up feature in such instruments.

xiv. The instrument may be callable at the initiative of the issuer after a minimum period of five years with prior approval of SBP.

xv. Neither a bank nor a related party over which the bank exercise control or significant influence can purchase the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument.

xvi. The banks before issuing any subordinated debt instruments for inclusion in Tier-2 capital will be required to obtain prior approval of SBP.

xvii. The issuing bank must clearly disclose in the offer documents that the instrument is unsecured, subordinated as to payment of principal and profit to all other indebtedness of the bank, including deposits and is not redeemable before maturity without prior approval of SBP. Moreover, the investors should be intimated that they have no right to accelerate the repayment of future scheduled payments (interest or principal) except in bankruptcy and liquidation.

xviii. Banks should indicate the amount/details of subordinated debt raised as supplementary capital by way of explanatory notes in their annual audited accounts and quarterly Statement of Capital Adequacy Return, as submitted to SBP.
In order for an instrument issued by a bank to be included in Tier 2 capital, it must meet or exceed minimum requirements to ensure loss absorbency set out in the Annexure-5 of SBP. BPRD Circular # 6 of 2013 dated August 15, 2013.

xix. Bank should not grant advances against the security of their own subordinated debt issue. While granting loans/advances against subordinated debt instruments of other banks, the margin requirement prescribed under Prudential Regulations shall be maintained, however, the bank's total financing against subordinated debt instruments issued by a bank should not exceed its total Tier-I capital less deductions. Further, the bank shall not provide any accommodation to finance purchase of its subordinated debt instrument.

xx. Bank's investment in a single issue of such TFCs of any other bank will not at any time exceed 5% of its own CET1 less deduction or 15% of the total size of the issue, whichever is less. Anything in excess of these thresholds will be deducted from CET1.

xxi. Bank's investment in subordinated debt issued by other banks/ financial institutions a. Will attract risk weight as per Section 2.4.8 and Credit Risk/ Market Risk Chapter of this document. b. Will be treated as exposure against shares/ TFCs for the purpose of prudential regulation ceilings proposed in R-6.

xxii. The issuing bank should submit a report to SBP giving details of the subordinated debt, such as amount raised, maturity of the instrument, rate of profit etc. within one month from the date of issue.

xxiii. The proceeds of rupee denominated debt instruments offered/issued to non-residents will have to be repatriated to Pakistan and converted into rupees by the bank concerned and the Proceeds Realization Certificate will be furnished to SBP. The bank concerned will be allowed to remit the principal amount of debt instruments at maturity as well as the profit/interest thereon from the interbank market. Hedging will not be available on such instruments. Banks should comply with all the terms and conditions, if any set out in any law in the country with regard to issue of such instruments.

Credit Rating

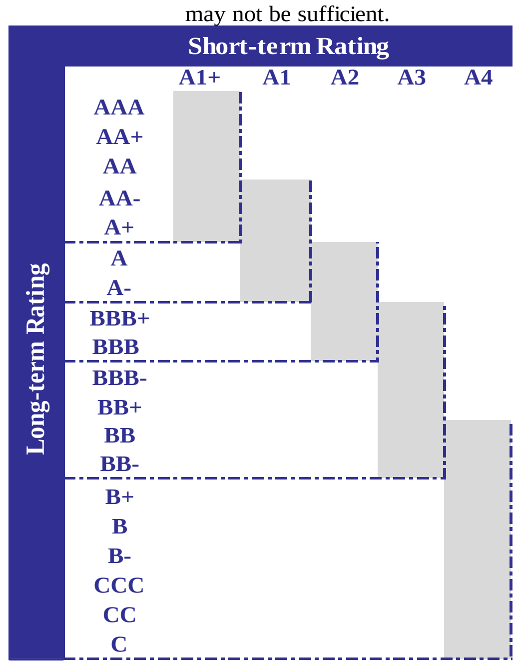
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long-term Rating

Scale	Definition
AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Short-term Rating

Scale	Definition
A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.



**The correlation shown is indicative and, in certain cases, may not hold.*

Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch Alerts to the possibility of a rating change subsequent to, or, in anticipation of some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating watch may accompany rating outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note. This scale is applicable to the following methodology(s):

Entities
a) Broker Entity Rating
b) Corporate Rating
c) Financial Institution Rating
d) Holding Company Rating
e) Independent Power Producer Rating
f) Microfinance Institution Rating
g) Non-Banking Finance Companies (NBFCs) Rating

Instruments
a) Basel III Compliant Debt Instrument Rating
b) Debt Instrument Rating
c) Sukuk Rating