

Ratings

Tier 2 under threat from Fitch draft, AT1 set for boost

Fitch's ratings of Tier 2 debt could be cut by one notch under proposed new rating criteria released in a report on 15 November, although AT1 instruments could be lifted one notch.

The report, "Exposure Draft: Bank Rating Criteria", specifies Fitch Ratings' methodology for assigning new ratings to banks and monitoring existing ratings. Fitch's proposed rating framework for banks is largely consistent with previous criteria with respect to the core VR and Support Rating aspects of the framework.

The most material changes proposed relate to notching applied to senior and subordinated (AT1 and Tier 2) unsecured debt:

- Fitch proposes a more forward-looking approach to determining when to notch up a senior debt rating, Derivative Counterparty Rating (DCR) and/or deposit rating:
 - Based on resolution plan and forward-looking issuance expectations — of note, no timeframe on forward-looking horizon provided by Fitch
 - For reference, Moody's takes MREL/TLAC issuance plans/targets up to three years in advance (base case two years), while S&P has a two year forward-looking horizon
 - Threshold for upgrade revised to a generic 10% of RWA — this replaces current framework of Fitch calculating individual recapitalization amounts on a per bank basis
 - 10% of RWA = approximation of 8% P1 + generic 2% P2R assumption (CACIB view)
 - For jurisdictions with general deposit preference (e.g. Portugal, Italy, Greece, Cyprus, Bulgaria, Romania, etc), Fitch will notch down senior (preferred) debt from the IDR (= VR + support, if any), to take into account situations where:
 - "debt buffers are thin or resolution debt buffers are likely to include more senior liabilities"
- Tier 2 debt notching (banks with VR of bbb- or above):
 - Currently Tier 2 debt is notched down one notch from the relevant rating anchor (typically the VR in the EU + UK)
 - Future proposed method: notch down twice from the relevant rating anchor (same approach as S&P; Moody's rates Tier 2 debt based on LGF outcome)
- AT1 debt notching (banks with VR of bbb- or above):
 - Currently AT1 debt is notched down five notches from the relevant rating anchor (typically the VR in the EU + UK)
 - Future proposed method: four notches down from the relevant rating anchor (same approach as S&P; Moody's typically three notches down)



- Of note, this is the base case notching for AT1 by Fitch. It remains to be seen whether additional notches will be applied for cases with heightened non-performance risk (e.g. risk of coupon reduction or cancellation due to low ADI or MDA)
- Additionally, Fitch suggests it can factor sovereign support more routinely into junior debt of banks with IDRs that are driven by sovereign support
- Fitch also proposes a new approach for its core capitalization metric. Where disclosed, Fitch proposes to use the regulatory Common Equity Tier 1 ratio instead of its existing approach based on Fitch Core Capital. If fully-loaded CET1 ratios are disclosed, this is the measure that Fitch intends to take, otherwise transitional CET1 ratios will be applied

Fitch is currently gathering market feedback until 31 December, after which it will consider the feedback and finalise the criteria. During the exposure draft period, it will apply the existing criteria to existing ratings, but will already apply the criteria described in the exposure draft to new rating assignments. We expect the finalisation to occur in 1H20.

With the base case Tier 2 notching of -2 (from -1), some banks' Tier 2 ratings are more at risk of falling into sub-investment grade category and losing index eligibility. Uni-Credit Tier 2 bonds (Baa3 Stable/BB+ Stable/BBB- Negative) may be vulnerable to falling back to sub-IG if downgraded by Fitch. This is after they received index eligibility on 18 July when Moody's upgraded its Tier 2 rating to IG. Tier 2 bonds from CaixaBank, Commerzbank and Aareal Bank could also be vulnerable because of the review, still remaining IG, but closer to sub-IG territory.

With the base case AT1 notching of -4 (from -5), notable beneficiaries include Lloyds (Baa3/BB-/BB+) and Nationwide (Baa3/BB+/BB+), with a Fitch upgrade resulting in two out of the three ratings being IG. ●

	Key Proposed Changes to Criteria	Potential Direct Rating Impact
Senior Debt and OpCo Notching	<p>Fitch proposes to notch up:</p> <ul style="list-style-type: none"> ● preferred senior debt (and, where relevant, deposit and derivative counterparty ratings) ● an OpCo's IDR in situations where it expects senior preferred creditors or OpCo senior creditors to be protected by a bank's or resolution entity parent's more junior debt in resolution. Some exceptions will exist, for example where a bank's IDR is driven by support, but it is notched down from the parent's IDR and/or is not part of the parent's resolution group. <p>Fitch also proposes that uplift for preferred senior obligations or for an issuer's IDR may occur where junior debt (or "qualifying junior debt" (QJD) in the case of an IDR) exceeds 10% of risk-weighted assets (RWA)</p>	<p>Multiple (potentially > 150) one-notch upgrades of preferred senior debt, OpCo IDRs, deposit ratings and DCRs mainly in EMEA, but some also in APAC and North America. A very small number of one-notch downgrades of IDRs and related ratings</p>
	<p>The maturing of bank resolution frameworks and the introduction in some jurisdictions of depositor preference mean that Fitch believes there is a heightened risk of below average recoveries on senior obligations in some situations. Unless certain conditions are met, Fitch proposes notching down from an issuer's IDR:</p> <ul style="list-style-type: none"> ● senior debt issued by banks in jurisdictions where deposits are preferred to the debt class, there is sophisticated bank resolution and where debt buffers are thin or resolution debt buffers are likely to include more senior liabilities ● BHC senior debt under some circumstances where debt buffers are thin. 	<p>In the region of 20 one-notch downgrades of senior debt ratings, mostly in EMEA</p>
Junior Debt Notching	<p>Fitch proposes:</p> <ul style="list-style-type: none"> ● to change the baseline notching for vanilla subordinated (Tier 2) debt to two notches from the relevant rating anchor from one notch to reflect a heightened risk of poor recoveries arising from subordination and further maturing of bank resolution frameworks as buffers of more senior bail-in debt are built. One notch will still be possible where loss severity risk is mitigated e.g. by thick debt buffers, prevalence of liquidity risks, partial support or precedent. 	<p>Multiple of one-notch downgrades of T2 debt that is currently notched once. Potentially >100 in EMEA, in the region of 30 in each of North America and APAC, and in the region of 10+ in LatAm</p>
	<ul style="list-style-type: none"> ● to change the baseline notching for Additional Tier 1 and US preferred securities to four notches from an issuer's VR from five notches at higher rating levels (anchor BBB-/bbb- or above) by reducing the incremental non-performance risk notching to two notches from three notches. The change is driven by a reduction in Fitch's assessment of the incremental non-performance risk in such bonds' fully flexible coupons and Fitch's assessment of the overall credit risk in such instruments versus other subordinated instruments. Where incremental risks are still considered high, three or more incremental non-performance risk notches may still be applied, resulting in total notching of five notches or more 	<p>Multiple one-notch upgrades of T1 debt that is currently notched five times. In the region of 40 in each of EMEA and North America (ultimate parent basis), with the balance in APAC and LatAm</p>
	<ul style="list-style-type: none"> ● to be able to factor sovereign support more routinely into junior debt (including AT1 debt) of banks whose IDRs are driven by sovereign support, while retaining existing rating caps. The proposed change reflects some instances of sovereign support for AT1 securities observed by Fitch 	<p>None</p>
New Core Capital Metrics	<p>Fitch proposes to use the regulatory Common Equity Tier 1 ratio (CET1). Where an "end-point" or "fully-loaded" CET1 ratio is reported, Fitch will use that, otherwise the transitional CET1 ratio will be used, if available. In some markets and circumstances, for example where a Basel-based CET1 ratio is not yet reported, Fitch will continue to use Fitch Core Capital (FCC)/FCC-adjusted risk-weighted assets</p>	<p>None</p>
Incorporation of Updated Short-Term Rating	<p>Fitch proposes to incorporate into this criteria report the updated short-term rating framework outlined in the cross-sector criteria report <i>Short-Term Ratings Criteria</i>, dated 2 May 2019. The two key updates are the incorporation of two new crossover points between long-term and short-term ratings and the use of an issuer's Funding & Liquidity factor score as the principal determinant of whether the "baseline" or "higher" short-term IDR is assigned at cusp points</p>	<p>None (all rating changes have taken place)</p>

Source: Fitch Ratings, CACIB