BANK SUBORDINATED BOND RATING METHODOLOGY

Introduction

In PEFINDO's view, the introduction of regulation 15/12/PBI/2013 by Bank Indonesia (BI) increases the risks faced by investors in subordinated bonds issued by banks since January 1, 2014, and all future issues of such instruments that fall under this regulation. PEFINDO believes that the increased risk of substantial losses to investors in the event of a bank experiencing financial difficulties necessitates a greater notching down of the ratings on these instruments from the issuing bank's corporate (or senior unsecured) rating.

Prior regulation and PEFINDO's methodology in rating these instruments

Prior to the implementation of regulation 10/15/PBI/2008, PEFINDO's approach was to rate a bank's subordinated bonds one notch below the bank's corporate rating, reflecting its subordinated position in the event of default. Following the implementation of the regulation, PEFINDO adapted this approach by rating a bank's subordinated bonds a minimum of one notch below its corporate rating, with the ultimate decision on notching to be considered on a case-by-case basis. Criteria in determining the degree of notching applied included the following:

I The strength of the bank's corporate rating, as assigned by PEFINDO;
II PEFINDO's assessment of the bank's capitalization profile;
III PEFINDO's assessment of the bank's profitability profile; and
IV PEFINDO's view of the likelihood of government support for the bank (and specifically its subordinated obligations) in the event of financial difficulty.

Subordinated bonds of banks were typically rated one notch below their corporate rating by PEFINDO. However, banks with a lower corporate rating had a greater probability of their subordinated obligations being rated more than one notch below the corporate rating, with points II to IV above among the determining factors in these cases.

Key changes in new regulation 15/12/PBI/2013

Among other things, the new regulation introduces the requirement for banks to hold additional capital buffers as follows:

- A capital conservation buffer for banks in BUKU III and IV (of 2.5% of risk-weighted assets - RWA)
- A countercyclical buffer for all banks (0% to 2.5% of RWA), and
- A capital surcharge for banks deemed to be a domestic systemically important bank (D-SIB, 1% to 2.5% of RWA).

The new buffers come into force from January 1, 2016, with the application of the capital conservation buffer to be introduced on a graduated basis (annual steps of 0.625%) and to be fully met by January 1, 2019.

In addition, the regulation sub-divides tier-1 capital (core capital) into common equity tier-1 (CET-1) capital and additional tier-1 capital. The regulation increases the minimum tier-1 capital ratio requirement to 6% (from 5%) and introduces a minimum CET-1 ratio of 4.5% (effective from January 1, 2014).

Furthermore, the regulation stipulates that from January 1, 2014 in order to qualify as supplemental capital an instrument must (among other conditions):

- Have a term of five years or more, with repayment only on BI approval
- Allow for payment of interest and/or principal to be deferred and accumulated should the payment result in the bank failing to meet its minimum capital adequacy requirements, and
- Be subject to write-down or conversion into common stock if the bank's survival is deemed to be in question (point of non-viability).

While the first two requirements above continue from the prior regulation, (although we note the more onerous capital requirements imposed on banks with the introduction of the various capital buffers) the requirement that the obligations are subject to write-down or conversion into equity is a new development. Under the regulation the authority to decide a bank's point of non-viability rests with the Financial Services Authority (Otoritas Jasa Keuangan, "OJK").

Implications of the new regulation

The new BI regulation imposes increased capital requirements on all banks; through the higher tier-1 capital requirement and the countercyclical buffer, but most particularly on the larger banks in the industry who will be subject to the capital conservation buffer (those with core capital of at least IDR 5 trillion who fall into either BUKU III or BUKU IV) and those banks deemed to be a D-SIB by the regulator. This requirement is immediate with regard to tier-1 capital, with an implementation date of January 1, 2016 for the various buffers (incorporating a staged introduction of the capital conservation buffer to January 1, 2019). Although PEFINDO views the Indonesian banking industry to be well-capitalized as a whole, as reflected by the industry average tier-1 capital ratio of 17.8% as of June 380, 2014, nonetheless we believe that the regulation will oblige many banks in the industry to raise fresh capital in advance of January 1, 2016 in order to meet the new requirements. In this regard, PEFINDO will continue to closely monitor the equity positions and capital raising plans of the banks in its portfolio vis-à-vis their respective requirements.

PEFINDO believes the introduction of the new regulation mirrors the spirit of the Basel III accords in seeking to shift some of the risk of bank failure from governments back to investors. Since January 1, 2014, all newly issued bank subordinated bonds must now include the point of non-viability clause in order to qualify as supplementary capital, whereby OJK can trigger the write-down of these obligations (in part or in full) or their conversion into equity. PEFINDO believes that these bonds subject investors to a greater risk of potential losses than legacy subordinated bonds (i.e. those issued prior to January 1, 2014), which do not have a point of non-viability clause in their terms. As a result, PEFINDO views that subordinated bonds issued under the new regulation warrant a greater notching down from a bank's corporate rating than legacy subordinated bonds.

Rating methodology for subordinated bond issues (Basel III-compliant)

There is no change to PEFINDO's existing approach to rating subordinated bonds issued prior to January 1, 2014. For subordinated bonds issued post-January 1, 2014, the criteria in determining the extent of notching of a bank's subordinated bond rating from its corporate (or senior unsecured) rating includes the following:

I. The strength of the bank's corporate rating, as assigned by PEFINDO, and
II. PEFINDO's assessment of the bank's capitalization profile and, more specifically, the bank's headroom above its minimum capital requirements.

Under the new methodology, subordinated bonds issued under the new regulation will be notched a minimum of two notches below the bank's corporate rating, with the ultimate decision on notching to be considered on a case-by-case basis.

Determining factors as to whether a bond is notched more than the minimum will, in particular, include consideration of the strength of the bank's corporate rating. Inherent in PEFINDO's rating hierarchy, PEFINDO's new methodology reflects that banks with a higher corporate rating are more likely to benefit from (among other things), more robust risk management practices (with better early warning systems), have greater financial flexibility, and, where applicable, receive a greater degree of parent support than those with a lower corporate rating. Thus, we believe that a higher rated bank is more likely to be able to anticipate and prevent the progression to its point of non-viability than a lower rated bank, and may thus warrant less notching to the ratings of its subordinated obligations than those of a lower rated bank.