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Requirements for Equity Content for Sustainability-Linked Hybrid Financing—Changes in Economic Conditions Linked to SPTs Do Not Affect Equity Content Assessment

The following is Japan Credit Rating Agency, Ltd. (JCR)'s opinion on equity content assessment in cases where companies issue and take out sustainability-linked bonds and loans to raise money in the form of hybrid financing.

(1) When Sustainability Linked Bonds/Loans (SLBs/SLLs) are structured as hybrid financing with equity content at the same time, it is necessary to consider how the setting of changes in economic conditions according to the achievement of the Sustainability Performance Targets (SPTs) required for the SLBs/SLLs affects the requirements for equity content assessment in hybrid financing. As a specific case, this type of financing has already been contemplated by The Chugoku Electric Power Company, Incorporated, and JCR has issued a third-party opinion (22-D-0454) and a preliminary rating and an equity content assessment (22-D-0429) for the financing on July 29, 2022. This draft describes JCR's approach in a more generalized form and provides information to issuers considering similar financing and investors.

(2) JCR's view is that changes in the economic conditions linked to SPTs in SLBs/SLLs basically have no impact on the equity content assessment of hybrid financing. The link between SPTs in SLBs/SLLs and the characteristics of such loan and bond is a setting based on the concept of providing incentives for issuers to improve their sustainable management. This is a setting based on a completely different perspective from three requirements for equity content assessment: permanence of principal, flexibility of interest payment, and subordination upon bankruptcy, and can be established as independent characteristics from each other.

(3) As an example, if the change in economic conditions is the interest rate, assuming the range of interest rate fluctuation linked to SPTs in the current market, whether it is an increase as a penalty or a decrease as an incentive, it can be viewed as an incentive to achieve the SPTs and is not included in the requirement for the equity content assessment with regard to interest rate step-up set in hybrid financing. This is because such interest rate changes are not perceived as a mechanism to increase the probability of early redemption by investors as well as issuers. In addition, JCR does not believe that requiring a donation act would have any effect on the issuer's decision regarding the timing of redemption. This is because the issuer has already considered the implementation of the donation act at the time of fund procurement, and JCR considers that there is no need to assume a situation in which the redemption date is accelerated to avoid the implementation of the donation act.

(4) Cases that should be carefully considered include those where the change in economic conditions is related to the timing of redemption or where the change in interest rates is so drastic that it could affect the decision on the timing of redemption. If these cases are treated as hybrid financing, it is clear that the permanence of principal related to the equity content assessment would be affected. In light of the fact that it is widely possible to set changes in the economic conditions linked to SPTs in a manner that does not affect equity content, however, JCR believes that there is a high possibility that these cases will naturally be excluded from the considerations.

(5) Amidst increasing demand for initiatives to realize a sustainable society, such as decarbonization, the sustainability goals to be achieved through SLB/SLL financing will help stabilize the issuer's future management base. On the other hand, depending on the issuer's situation, the investment burden may lead to an increase in debt, which could negatively impact the issuer's current ability to repay debt. In order to mitigate such an impact on creditworthiness, SLB/SLL financing as a hybrid financing with equity content would be one of the effective options in the issuer's financial strategy.

(6) From a sustainable finance perspective, the characteristics of hybrid financing do not affect the eligibility assessment for SLB/SLL. JCR believes that rather these types of financing prominently represent characteristics of sustainable finance, which has been extended to three dimensions with impact added to the traditional two dimensions of risk and return and that these types of financing is significant in broadly encouraging issuers and investors to invest more to achieve sustainability goals.

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