News Release

Japan Credit Rating Agency, Ltd.

25-D-1524
February 9, 2026

JCR Solicits Public Comments on Revisions to Rating Methodology by Sector “Life Insurance” and “Non-life Insurance” and “Rating Methodology for Financial Institutions’ Capital and TLAC Instruments”

Japan Credit Rating Agency, Ltd. (JCR) is considering revisions to the rating methodology by sector “Life Insurance” and “Non-life Insurance” and “Rating Methodology for Financial Institutions’ Capital and TLAC Instruments” as described below and solicits opinions on the proposed rating methodology.

1. Outline

JCR is considering revising the aforementioned three sets of rating methodologies as described in the attachment.

Insurance companies will begin calculating and reporting Economic Value-based Solvency Ratio (ESR) under the economic value-based solvency regulations (new regulations) from the end of the fiscal year ending March 2026. Under the new regulations, a structure for eligible capital has been rebuilt. JCR has to date evaluated the equity content of fundraising by insurance companies, including hybrid securities, based on the same considerations as those applied to operating companies, etc. and determined a rating notch. In light of the new regulations, JCR has reorganized its approach to regulatory capital in rating assessments and reflected revisions regarding the equity content and notching in the rating methodologies.

2. Future Plans

JCR solicits public comments on this matter. Comments will be accepted by e-mail to “Contact Us” on JCR website until February 20. JCR plans to finalize this rating methodology in about one or two months. There will be no existing individual ratings that need to be reviewed.

Kiichi Sugiura, Tomohiro Miyao, Seito Achiha, Kota Matsuzawa

Japan Credit Rating Agency, Ltd.
Jiji Press Building, 5-15-8 Ginza, Chuo-ku, Tokyo 104-0061, Japan
Tel. +81 3 3544 7013, Fax. +81 3 3544 7026

Attachment

Draft for Public Opinions

Rating Methodology by Sector

Life Insurance

This rating methodology mainly applies to life insurance companies and life insurance groups in Japan. It also applies to mutual aid corporations that handle life mutual aid. For overseas life insurance companies and others, JCR applies this rating methodology after making necessary adjustments to the analytical indicators based on the laws, accounting systems, regulations, and financial administration, etc. in the country or region where those companies are located.

1. Business Foundation

(1) Industry Characteristics

(i) Market size and growth potential

The life insurance business handles insurance products for the survival or death of a person (so-called first sector) and bodily injury or illness (so-called third sector) in accordance with the Insurance Business Act.

The life insurance market is large and expanding moderately. Life insurance is based on the principle of mutual assistance and has a social mission to provide security throughout one's life. Japan's population is on a declining trend, and demographic changes due to the falling birthrate and aging population, as well as the diversification of lifestyles, such as the increase in nuclear families and single-person households, are expected to further develop. While needs for death benefits are declining, there is room for growth in third-sector products such as medical insurance that address the risk of longevity, and annuity insurance products to secure funds for retirement and to support retirement living. Although it is difficult to expect high growth in the life insurance market, JCR believes that the market is unlikely to shrink rapidly.

(ii) Competition

The life insurance business is licensed, and there are relatively high barriers to entry. On the other hand, the life insurance household participation rate is very high, and in addition to traditional domestic life insurance companies, there are many foreign and non-life insurance companies competing in this mature market. As for sales channels, the sales staff channel held by traditional life insurance companies continues to have a large presence, but they are diversifying and becoming more specialized, such as joint agencies (insurance shops), bancassurance, and direct (Internet) channels. Life insurers have little room for differentiation in their products, so it is not easy for them to secure a competitive advantage. Although there is a certain amount of competition in all sales channels, major life insurers have a reasonable share of the market, and the growing awareness of risk and return due to the prevalence of ERM (Enterprise Risk Management) is making excessive price competition less likely.

(iii) Transaction stability

Life insurance products are not patent subjects, and even if a company develops a product that captures customer needs, it is likely to be followed by competitors. In addition to being long-term contracts, life insurance products are unlikely to be cancelled or switched because premiums generally increase as the age of participation increases and there are surrender charges. The stability of transactions is also supported by the strong grip on customers by sales staff and the company's coping with the obsolescence of coverage through a conversion system. On the other hand, some savings-type products are susceptible to switching to more advantageous products due to changes in market conditions, such as rising interest rates and exchange rate fluctuations.

(iv) Protection and regulation

Life insurance companies are supervised by Financial Services Agency and are required to calculate a solvency margin ratio, which assesses financial soundness by measuring the amount of risks (required capital) based on economic value assessments of assets and liabilities and evaluating the ratio of capital (eligible capital) against it. Partly because the ratio is calculated based on economic value, it is referred to as ESR (Economic Value-based Solvency Ratio). If ESR falls below 100%, early corrective measures are triggered in stages according to the degree of the shortfall.

In addition, life insurance companies are subject to bankruptcy resolution procedures under the Insurance Business Act and the Act on Special Measures for the Reorganization Proceedings of Financial Institutions. Policies of a failed life insurance company may be continued after its bankruptcy through transfer of policies by a bailout company, merger, share acquisition, etc. However, reduction of policy reserve may be implemented. In such cases, Life Insurance Policyholders Protection Corporation of Japan will, in principle, compensate up to 90% of the policy reserve at the time of bankruptcy, except for policies with a high assumed interest rate, in accordance with the Insurance Business Act and other regulations. In addition to reductions in policy reserve, policy terms and conditions may be changed, such as reductions in assumed interest rates.

On the other hand, financial system incorporates various measures (prudential policies) to maintain stability and efficiently function. The expected protection for insurance companies and insurance holding companies is weak compared to that of banks.

(2) Market Position and Competitiveness

The market position and competitiveness of life insurance companies are important for ensuring stable earnings over the medium to long term. The depth and characteristics of the customer base, diversity of sales channels and sales capabilities, uniqueness of product and management strategies, brand power, and high customer convenience through the use of digital and other means determine market position and competitiveness.

Regarding the customer base, JCR evaluates the number of customers (policyholders), characteristics of the customer segment, and the size and stability of in-force contracts. In order to build a stable customer base, it

is important to secure stable contract performance. JCR evaluates the stability of in-force contracts not only in terms of size, but also in terms of the fact that in some cases the company has a presence in its own customer base, such as belonging to a particular corporate group.

JCR evaluates how well the new customers are being acquired by the sales channel's sales force and product appeal. For the sales channel, JCR confirms whether the company is accurately capturing diversifying customer needs. In the sales staff channel, JCR evaluates the sales force based on the age group and job classification of sales staff, as well as the state of recruitment and training, and sales efficiency. In the agency channel, JCR qualitatively evaluates business relationship between the life insurance company and its agents and strength of ties between them. In terms of product strategy, in addition to the fullness of product lineup, key point is whether the company is able to quickly and flexibly respond to changes in customer needs. It is not easy to differentiate its products from those of other companies, and merchantability (ease of understanding), marketing ingenuity, and skillful promotion are related to the differentiation.

(3) Management Strategy and Governance

Management strategy and governance are factors that affect the direction of business foundation, and also financial foundation. With regard to management strategy, JCR evaluates whether the company is able to formulate and execute a management strategy that takes into account changes in the business environment. JCR also focuses on the direction of risk appetite and the extent to which the ERM culture has penetrated within the company. With regard to governance, JCR checks whether a check-and-balance function adequately is functioning through the corporate governance system, such as the board of directors, management control system, risk management and internal control such as compliance, while taking into account the size of the organization. In the event of misconduct, risk of damage to the business foundation due to loss of reputation will become apparent. Therefore, JCR checks whether a system is in place to prevent misconduct from occurring, and whether a system will be in place to prevent similar incidents from recurring in the future when such misconduct has occurred.

2. Financial Foundation

(1) Earnings Power

In evaluating earnings power, JCR focuses primarily on economic value-based indicators. In particular, JCR checks trends in the value of new business, a component of Embedded Value (EV), which represents corporate value based on economic value. In addition, trends in financial accounting-based earnings, including core profit, are referenced. To ensure stable new business value and core profit, it is essential to analyze trends in contract performance.

For economic value-based indicators, emphasis is placed on the accumulation of "the amount of increase in EV associated with the results of sales activities," such as the value of new business, but it should be noted that the assumptions made differ from company to company. Since third-sector products have relatively high profitability in terms of economic value, JCR confirms whether the product portfolio is optimized to

accumulate the value of new business, based on the diversification of products. The level of new business margin and control of sensitivity to market fluctuations such as interest rates and stock prices are also key points. At the same time, JCR also analyzes profitability by product, centered on core products.

Earnings power on a financial accounting basis is evaluated based on trends in core profit. With regard to insurance-related profit/loss of the core profit, JCR focuses on the balance between premium revenue and insurance claims/benefits payments or operating expenses. Regarding mortality gains/losses, while traditional mortality insurance is likely to easily have a profit outlook based on historical data, JCR pays attention to the possibility that the actual incidence rate for medical and nursing care insurance may deviate from the projected incidence rate based on data against the backdrop of advances in medical technology and system changes related to medical care and nursing care. In addition, since a decline in contract performance can lead to a reduction in the cost burden of new policies and other expenses, and core profit can swing upward in the short term, JCR does not view increases or decreases in core profit as a straightforward indication of trends in earnings power.

JCR evaluate trends in contract performance, which is the source of earnings power. Particular attention is paid to annualized new business premiums, which are a flow-based indicator. In addition to the acquisition of new policies, JCR checks the composition ratio of protection products and savings products, as well as the composition ratio of third-sector products. As for annualized premiums in-force, which are a stock-based indicator, JCR confirms whether the company is maintaining a reasonable policy size. For insurers that emphasize the provision of death benefits, it may be appropriate to check the trends of amount of new policies and the amount of in-force policies as indicators.

Key financial indicators

- New business value, new business margin
- EV
- Core profit (interest gains (losses), mortality gains (losses), and expense gains (losses))
- Annualized premiums (new business, policies in-force)

(2) Asset Quality (Asset Management)

ALM is extremely important in the asset management of a life insurance company, and JCR confirms whether the company has built an asset portfolio that is consistent with the characteristics of the insurance liabilities. If asset management is not consistent with the characteristics of insurance liabilities, negative spread on long-term life insurance products may put pressure on profitability. Since the risk-return approach to asset management differs depending on the asset management policy of each company, it should be noted that the composition of securities, real estate, loans, and other assets, which account for the majority of assets held, differs. Based on the composition of investment assets, JCR checks the risk of each individual asset and the diversification effect of the assets as a whole. It is important to secure investment income in order to maintain profits for financial accounting purposes. Based on the recognition of the basic risk-taking policy, JCR

evaluates the appropriateness of the investment stance, adequacy of personnel and systems for asset management, and status of securing returns.

Key financial indicator

- Composition ratio of asset portfolio

(3) Capital Adequacy

Regarding the financial foundation, JCR places the greatest emphasis on capital adequacy from a quantitative perspective, evaluating capital adequacy in terms of economic value, which is a market value assessment of assets and liabilities as a whole.

As an indicator, JCR pays particular attention to ESR. Since ESR is a numerical value based on internal management-based risk management and differs in terms of assumptions, JCR evaluates ESR by paying attention to trends in regulations and changes in calculation standards both in and outside Japan. While internal management-based ESR, which represents the characteristics of each company, is the main target of the assessment, JCR also incorporates regulatory-based ESR whose prerequisites are standardized to a certain extent for comparability. As regards funding instruments that meet regulatory capital requirements, including hybrid securities that have the characteristics of both equity and liabilities, JCR basically incorporates them into the assessment by taking into account their equity content equivalent to regulations.

The effective components of capital for confirming capital adequacy ratio based on financial accounting include capital stock and capital surplus (joint-stock companies), funds and reserve for redemption of funds (mutual companies), as well as various reserves such as price fluctuation reserve, contingency reserve and policy reserve in excess of surrender values.

Many life insurance companies hold long-term insurance policies and thus have long liability durations. Therefore, they are exposed to interest rate risk arising from the duration gap between assets and liabilities, which varies from company to company. It is important to reduce the amount of interest rate risk through duration matching (shortening the duration gap), cash flow matching, and other measures and control sensitivity to changes in economic assumptions. In addition to appropriately controlling the amount of risk, including other asset management risks, JCR confirms whether the company has stabilized the level of ESR by building up capital through measures such as securing the value of new business.

Key financial indicators

- Solvency margin ratio (ESR)
- Capital adequacy ratio

(4) Liquidity

Regarding liquidity, JCR confirms that the company possesses highly liquid assets that enable it to respond quickly in times of stress, such as a sharp increase in insurance claims/benefit payments or cash surrender

values. JCR confirms that liquidity risk management is in place to enable reliable payment even if market risk or credit risk materializes during a financial crisis. A sharp increase in claims and benefit payments happens when a large-scale disaster occurs, a covered disease or other event becomes prevalent and morbidity and mortality rates are much higher than assumed at the time of product design. A sharp increase in cash surrender values for savings-type products could be assumed in cases of dynamic cancellations, where cancellations increase due to switching to more advantageous products when the market fluctuates, or in cases where the reputation of the life insurance company is severely damaged due to a deterioration in the business conditions.

Key financial indicator

- Liquid assets (cash, deposits, government bonds, etc.)

(5) Risk Management System

JCR focuses on the integrated management system of earnings and capital based on risk management, and checks the status of ERM development and progress in upgrading it. While excellent risk management is unlikely to be a positive factor in the evaluation, it can be a negative factor if it is considered that there is room for improvement in risk management. JCR mainly evaluates whether the company has incorporated an economic value-based approach into its management strategy and has secured an appropriate balance between risk and return. JCR also confirms whether the company comprehensively and accurately assesses various types of risks, identifies risks that have a significant impact on management, and can appropriately allocate capital accordingly. For effective risk management, it is necessary to elaborate and upgrade the risk management system.

In the life insurance business, there is a risk that the increasing frequency of payment events for third-sector products due to advances in medical technology and changes in the system will put pressure on profits. JCR takes the evaluation based on management conditions, such as payment trends of insurance claims and benefits and monitoring of morbidity rates, into consideration. In addition, JCR also confirms whether major life insurers have a global and group-wide ERM system in place, given the trend toward an increase in the number of group companies in Japan and overseas. The “Own Risk and Solvency Assessment (‘ORSA’) reports” are a useful tool for understanding the status of ERM and risk management systems.

Japan Credit Rating Agency, Ltd.
Jiji Press Building, 5-15-8 Ginza,
Chuo-ku, Tokyo 104-0061, Japan
Tel. +81 3 3544 7013, Fax. +81 3 3544 7026

Attachment

Draft for Public Opinions

Rating Methodology by Sector

Non-life Insurance

This rating methodology mainly applies to non-life insurance companies and non-life insurance groups in Japan. It also applies to mutual aid corporations that handle non-life mutual aid. For overseas non-life insurance companies and others, JCR applies this rating methodology after making necessary adjustments to the analytical indicators based on the laws, accounting systems, regulations, and financial administration, etc. in the country or region where those companies are located. Similarly, for specialized reinsurance companies, JCR applies this rating methodology, paying attention to the characteristics of business, location of risks, and nature of the system.

1. Business Foundation

(1) Industry Characteristics

(i) Market size and growth potential

The non-life insurance business handles insurance products for losses caused by certain accidental events (so-called second-sector) and bodily injury and illness (so-called third-sector) in accordance with the Insurance Business Act.

The non-life insurance market is large and expanding moderately. Non-life insurance is an indispensable function for the stability of people's lives and the sound development of the economy, and as society's risks become more diversified, new needs arise there. Japan's population is on a declining trend, and demographic changes due to the falling birthrate and aging population are expected to further develop. Although it is difficult to expect high growth in the non-life insurance market due to the limited expansion of needs for traditional non-life insurance such as automobile insurance, JCR believes that the market is unlikely to shrink rapidly.

With regard to automobile insurance, which is the main product of many non-life insurers, the impact of the penetration of CASE (connected, automated driving, sharing, and electrification) and MaaS (Mobility as a Service) is expected, among others. Although JCR does not expect the automobile insurance market to change significantly in the short run, it is necessary to monitor the spread of automated vehicles, environmental improvements, and legislative measures from a medium- to long-term perspective.

(ii) Competition

The non-life insurance business is licensed, and there are relatively high barriers to entry. As for sales channels, exclusive agents continue to have a large presence, but they are diversifying, such as joint agencies (insurance shops), bancassurance, and direct (Internet) channels. Non-life insurers have little room for differentiation in their products, so it is not easy for them to secure a competitive advantage. Although there is a certain amount

of competition in all sales channels, the market is dominated by major non-life insurers, and the growing awareness of risk and return due to the prevalence of ERM (Enterprise Risk Management) is making excessive price competition less likely.

(iii) Transaction stability

Non-life insurance products include automobile, fire, marine, and personal accident insurance, as well as liability insurance, expense/ profit insurance, workers' compensation and employers' liability insurance, and pet insurance (so-called new types of insurance). Non-life insurance products are not patent subjects, and even if a company develops products that captures customer needs, it is likely to be followed by competitors. Contract terms are relatively short, and contracts are basically renewed each time the maturity date arrives. Currently, there is no significant difference in product quality, and since agents, who account for the majority of sales channels, have a strong grip on customers, cancellations and switching are unlikely to occur, and the policy persistency rate is stable at a high level.

(iv) Protection and regulation

Non-life insurance companies are supervised by Financial Services Agency and are required to calculate a solvency margin ratio, which assesses financial soundness by measuring the amount of risks (required capital) based on economic value assessments of assets and liabilities and evaluating the ratio of capital (eligible capital) against it. Partly because the ratio is calculated based on economic value, it is referred to as ESR (Economic Value-based Solvency Ratio). If ESR falls below 100%, early corrective measures are triggered in stages according to the degree of the shortfall.

In addition, non-life insurance companies are subject to bankruptcy resolution procedures under the Insurance Business Act and the Act on Special Measures for the Reorganization Proceedings of Financial Institutions. Non-life Insurance Policy-holders Protection Corporation of Japan has been established to protect policyholders of bankrupt non-life insurance companies by providing financial assistance for the transfer of insurance policies of bankrupt insurance companies and the payment of covered insurance claims.

On the other hand, financial system incorporates various measures (prudential policies) to maintain stability and efficiently function. The expected protection for insurance companies and insurance holding companies is weak compared to that of banks.

(2) Market Position and Competitiveness

The market position and competitiveness of non-life insurance companies are important for ensuring stable earnings over the medium to long term. The depth and characteristics of the customer base, diversity of sales channels and sales capabilities, uniqueness of product and management strategies, brand power, and high customer convenience through the use of digital and other means determine market position and competitiveness.

Regarding the customer base, JCR evaluates the number of customers (policyholders), characteristics of the

customer segment, and the size and stability of net premiums written. Some non-life insurers, for example, belonging to certain corporate groups, have defended themselves against competitors' offensives in their customer bases with their unique channel and product strategies, and have a high presence over a long period of time. JCR also incorporates into its evaluation the possibility that such non-life insurers will demonstrate earnings power for the future.

JCR evaluates how well the new customers are being acquired by the sales channel's sales force and product appeal. For the sales channel, JCR confirms whether the company is accurately capturing diversifying customer needs. In particular, it is important whether the company has established an appropriate relationship with agency channel. In terms of product strategy, in addition to the fullness of product lineup, key point is whether the company is able to quickly and flexibly respond to changes in customer needs. It is not easy to differentiate its products from those of other companies, and merchantability (ease of understanding), marketing ingenuity, and skillful promotion are related to the differentiation.

(3) Management Strategy and Governance

Management strategy and governance are factors that affect the direction of business foundation, and also financial foundation. With regard to management strategy, JCR evaluates whether the company is able to formulate and execute a management strategy that takes into account changes in the business environment. JCR also focuses on the direction of risk appetite and the extent to which the ERM culture has penetrated within the company. With regard to governance, JCR checks whether a check-and-balance function adequately is functioning through the corporate governance system, such as the board of directors, management control system, risk management and internal control such as compliance, while taking into account the size of the organization. In the event of misconduct, risk of damage to the business foundation due to loss of reputation will become apparent. Therefore, JCR checks whether a system is in place to prevent misconduct from occurring, and whether a system will be in place to prevent similar incidents from recurring in the future when such misconduct has occurred.

2. Financial Foundation

(1) Earnings Power

In evaluating earnings power, in addition to the scale of earnings and stability of profits from the core insurance business, JCR also analyzes the earnings power of the asset management. While future performance will be factored into the evaluation, JCR takes into account the possibility that changes in the business environment and management strategy can bring changes to the earnings structure of non-life insurance companies, in addition to past performance trends. JCR also takes into account risk-return balance, as non-life insurers have different risk profiles.

In analyzing earnings power, JCR focuses on the level of the combined ratio. Since profit of non-life insurance companies is subject to fluctuation due to the occurrence of major natural disasters such as windstorms, floods, and earthquakes, as well as major accidents, JCR confirms a profit level with one-time

effects leveled off by taking it as a moving average over a certain period. It is extremely important for non-life insurers to build a well-diversified business portfolio in terms of risk type and geographic location to ensure profit stability, and JCR pays attention to the status of such efforts. JCR also confirms the extent to which the volatility of periodic profit/loss is controlled based on the company's policies for the establishment of reinsurance schemes and the accumulation of catastrophe loss reserve.

It is also important to confirm that the company has set appropriate premium rates commensurate with risk. For automobile and fire insurance, which are the main products in the retail sector, profitability could deteriorate if premiums are not set in line with the actual loss ratios, referring to the advisory pure premium rates calculated by General Insurance Rating Organization of Japan. For corporate non-life insurance, which is more individualized, it is important to check whether the company sets premiums in accordance with its own loss ratio and risk status, and also can control revenue and expenses appropriately by, for example, limiting underwriting of excessive risks. In the field of new types of insurance, products must be designed based on appropriate risk management, such as ensuring profitability, because they cover specific risks that are not covered by traditional non-life insurance. For insurance types with deteriorating profitability, JCR checks the adequacy and progress of measures to improve profitability, such as policies for premium rate revision and product revision, and restrictions on or stricter underwriting.

With regard to asset management, JCR mainly analyzes income gains from interest-bearing bonds, which are expected to contribute to securing stable earnings over the medium to long term. JCR takes into account that capital gains/losses are in many cases easily influenced by market conditions. JCR checks medium-term trends, such as whether the balance of investment assets has been built up to generate stable income that is less susceptible to temporary increases or decreases due to aggressive risk-taking.

Key financial indicators

- Combined ratio
- Net premiums written
- Underwriting profit (loss)
- Investment income (loss)

(2) Asset Quality (Asset Management)

Although the asset allocation, risk and return of each asset varies among non-life insurers, JCR analyzes whether they secure returns commensurate with risk while controlling price fluctuation risk and interest rate risk by managing assets in a way that matches the characteristics of the liabilities. JCR also makes an analysis of ALM and risk management techniques, composition of investment assets, and derivatives transactions. Since the risk-return approach to asset management differs depending on the asset management policy of each company, it should be noted that the composition of securities, real estate, loans, and other assets, which account for the majority of assets held, differs. Based on the composition of investment assets, JCR checks whether the risk of each individual asset is not excessively large relative to capital and others and the

diversification effect of the assets as a whole. Based on the recognition of the basic risk-taking policy, JCR evaluates the appropriateness of the investment stance, adequacy of personnel and systems for asset management, and status of securing returns.

Key financial indicator

- Composition ratio of asset portfolio

(3) Capital Adequacy

Regarding the financial foundation, JCR places the greatest emphasis on capital adequacy from a quantitative perspective, evaluating capital adequacy in terms of economic value, which is a market value assessment of assets and liabilities as a whole.

As an indicator, JCR pays particular attention to ESR. Since ESR is a numerical value based on internal management-based risk management and differs in terms of assumptions, JCR evaluates ESR by paying attention to trends in regulations and changes in calculation standards both in and outside Japan. While internal management-based ESR, which represents the characteristics of each company, is the main target of the assessment, JCR also incorporates regulatory-based ESR whose prerequisites are standardized to a certain extent for comparability. As regards funding instruments that meet regulatory capital requirements, including hybrid securities that have the characteristics of both equity and liabilities, JCR basically incorporates them into the assessment by taking into account their equity content equivalent to regulations.

The effective components of capital for confirming capital adequacy ratio based on financial accounting include capital stock and capital surplus, as well as various reserves such as price fluctuation reserve and catastrophe loss reserve.

In general, non-life insurance companies have shorter asset and liability durations and smaller duration gaps than life insurance companies. Therefore, ESR of non-life insurance companies is less sensitive to interest rates than that of life insurance companies and remains stable. While considering ESR as a quantitative indicator, JCR pays attention to whether risk buffers are sufficiently secured through risk-based capital management, such as sales of cross-shareholding shares and underwriting risk through the use of reinsurance.

Key financial indicators

- Solvency margin ratio (ESR)
- Capital adequacy ratio

(4) Liquidity

Regarding liquidity, JCR confirms that the company possesses highly liquid assets that enable it to respond quickly in times of stress, such as an occurrence of a major natural disaster. JCR confirms that liquidity risk management is in place to enable reliable payment even if market risk or credit risk materializes during a financial crisis. A sharp increase in cash surrender values for savings-type products could be assumed in cases of dynamic cancellations, where cancellations increase due to switching to more advantageous products when the market fluctuates, or in cases where the reputation of the non-life insurance company is severely damaged

due to a deterioration in the business conditions.

Key financial indicator

- Liquid assets (cash, deposits, government bonds, etc.)

(5) Risk Management System

JCR focuses on the integrated management system of earnings and capital based on risk management, and checks the status of ERM development and progress in upgrading it. While excellent risk management is unlikely to be a positive factor in the evaluation, it can be a negative factor if it is considered that there is room for improvement in risk management. JCR mainly evaluates whether the company has incorporated an economic value-based approach into its management strategy and has secured an appropriate balance between risk and return. JCR also confirms whether the company comprehensively and accurately assesses various types of risks, identifies risks that have a significant impact on management, and can appropriately allocate capital accordingly. For effective risk management, it is necessary to elaborate and upgrade the risk management system.

In the non-life insurance business, since the impact of large-scale natural disasters and major accidents is inevitable, it is extremely important for non-life insurers to build a well-diversified business portfolio in terms of risk type and geographic location. In addition, JCR also confirms whether major non-life insurers have a global and group-wide ERM system in place, given the trend toward an increase in the number of group companies in Japan and overseas. The “Own Risk and Solvency Assessment (‘ORSA’) reports” are a useful tool for understanding the status of ERM and risk management systems.

Japan Credit Rating Agency, Ltd.
Jiji Press Building, 5-15-8 Ginza,
Chuo-ku, Tokyo 104-0061, Japan
Tel. +81 3 3544 7013, Fax. +81 3 3544 7026

Attachment

Draft for Public Opinions

Rating Methodology for Financial Institutions' Capital and TLAC Instruments

1. Scope of this methodology and its relations with other methodologies

This methodology covers (a) subordinated bonds, subordinated loans, preferred capital securities, preferred shares and funds that are issued by financial institutions and treated as their capital for regulatory or accounting purposes ("capital instruments"); and (b) instruments that are issued by financial institutions and eligible for their Total Loss-Absorbing Capacity (TLAC) for regulatory purpose ("TLAC instruments"). The financial institutions hereof include deposit-taking institutions, bank holding companies, insurance companies, insurance holding companies, securities companies and designated parent companies. Sections 3. through 7. primarily describe the concept of capital instruments issued by deposit-taking institutions, bank holding companies, securities firms and others, whereas Section 8. describes the concept of capital instruments issued by insurance companies and insurance holding companies.

This methodology stems from JCR's methodology for general hybrid securities published as "Ratings of Hybrid Securities" dated September 1, 2006. To any capital instruments that are not within the scope of this methodology, the said methodology for general hybrid securities will be applied. That said, should such capital instruments share major contractual or statutory provisions ("contractual/statutory provisions") and risk profile as described below, this methodology may be applied even if they are issued by other types of financial institutions.

This methodology is also applicable to the capital and TLAC instruments issued by foreign financial institutions with necessary adjustment. JCR will carefully examine the legislations and financial supervision of the located jurisdiction and determine the ratability as such factors may critically affect our assessment.

2. Policy for ratability judgment

(1) Principles

Capital and TLAC instruments issued by financial institutions would normally impose losses to their investors upon hitting a predetermined trigger as per their contractual/statutory provisions. However, should such trigger contain certain elements that make us unable to judge whether it is hit or to evaluate its likelihood, JCR, in principle, will not rate those instruments. Such cases include: (a) Wordings or description of the contractual provisions are extremely unclear; (b) The trigger includes discretionary judgment by non-issuers including the regulator, and the evaluation of their stance for exercising such discretion is extremely difficult; (c) The trigger includes certain elements that are not directly related to the issuer's debt repayment capacity such as share prices; and (d) The trigger includes JCR's or others' rating on the issuer.

Rating assignment entails an exercise to gauge the distance to an event which could incur loss to the investors of the rated instrument. The cases of (a)-(c) above would make it extremely difficult to measure such distance

to loss. The case (d) does not have such issue as it is linked to the issuer's debt repayment capacity and the indicator is clear. However, if JCR's rating were used as a trigger, this would impose us to "project its own rating trajectory", a self-fulfilling or tautological process. This also jeopardizes JCR's position as a third party being independent from issuers and investors as JCR may directly pull the trigger that determines the level of rating. Therefore, as a matter of principle, JCR will not rate such instruments. Even if the referenced rating came from another rating agency, we believe that it would make us difficult to assess the likelihood of the trigger being hit.

(2) Capital and TLAC instruments issued by the financial institutions in major advanced countries

JCR is of the view that, in the cases of capital and TLAC instruments issued by financial institutions in major advanced countries including Japan, we may preclude extreme uncertainty or unpredictability that would make us unable to rate. This is because: (a) Financial institutions' resolution system is well developed; (b) We could easily outline how these instruments would be treated upon resolution; and (c) The authorities also tend to adhere to the administrative continuity. That said, these instruments are still in the evolving stage. New provisions or wordings of many different sorts may emerge as triggers. Therefore, JCR will verify our ratability on each instrument by individually examining whether it does not fall into any of the categories as described above.

3. Rating and notching

Like general hybrid securities, capital and TLAC instruments issued by financial institutions are normally designed in a manner that, even though investors bore losses as a result of activation of predetermined contractual/statutory provisions and resultant cut in their principal or interest, that itself would not be construed as a legal default (non-fulfillment of liability). However, JCR will assign a "D" rating even to such loss that is driven by contractual/statutory provisions and express the distance to such loss by using the same rating symbols. This is due to the investors' needs that focus on the certainty of full and timely principal and interest payments. This is the same treatment as that for deferred payments of interest/dividend in other general hybrid securities.

Ratings for hybrid securities are applied a "notching approach". In other words, their ratings are notched down from their issuers' Long-term Issuer Rating. This is to reflect the following risks through notch-down: (a) Hybrid securities are subordinated to senior debt in the order of claims at the time of issuer's bankruptcy and hence their recoverability is lower; and (b) The distance to loss (driven by contractual/statutory provisions) could be shorter than the distance to legal default. Capital and TLAC instruments issued by financial institutions are also rated with the same approach, paying attention to (a) the recoverability and (b) the distance to loss.

JCR views that, from the standpoint of objectivity, it would be ideal to apply this notching approach to capital and TLAC instruments, judging from the types and contents of their contractual/statutory provisions. Specific notching rules will be explained later. That said, depending on an issuer's or other conditions, there

may be some cases where the scale of risks may not be captured properly by simply applying the somewhat mechanical notching rules. This may be because, at times, issuers' operational performance or financial environment, keys to hit the trigger, could get much more volatile than anticipated. Also, activations of the trigger may rest on the willingness or intention of an issuer or the authorities, which are hard to generalize and require qualitative assessment. Therefore, JCR would gauge the distance to loss from various angles and, if the notching rules alone may not reflect the actual risks of principal/interest loss for the rated instruments, assign ratings based on the distance to loss using the definition of each rating symbol. In such case, notching difference between such capital instrument and the issuer's Long-term Issuer Rating could be wider.

4. Notching due to recoverability

In ratings capital and TLAC instruments issued by financial institutions, it would need to take into account the risk that recoverability (or loss severity) upon non-fulfilment of timely principal/interest payments could be different from senior debt. For capital instruments issued by financial institutions, JCR, in principle, notches down by one level (1 notch down) from its Long-term Issuer Rating based on the lower recoverability. This is because they normally have a subordinate clause that makes it subordinated in the order of claims at the time of legal bankruptcy, For TLAC instruments including those that do not qualify the capital instruments such as TLAC eligible senior debt, JCR also, in principle, notches down by one level (1 notch down) from its Long-term Issuer Rating if the recovery of such instruments is subordinated to other uncollateralized senior debt.

This notch-down due to different recoverability is purely based on a judgment whether it is subordinated to uncollateralized senior debt. Even though the ranking of claims is different between capital and TLAC instruments, such difference is, in principle, not represented. The level of notch-down due to lower recoverability would be, in principle, always one level (1 notch down) for any instruments regardless of the different order of claims for different instruments (e.g., subordinated debt and preferred shares).

5. Notching due to distance to loss

(1) Notching rules

For capital and TLAC instruments issued by financial institutions, the distance to loss could be shorter than that for senior debt. This is because suspension of interest/dividend payment or write-down or conversion of principal may take place even ahead of the issuer's legal default. Many of the financial institutions' capital instruments have a number of contractual provisions that could inflict losses prior to legal default. Among such multiple contractual/statutory provisions, JCR, basically, specifies the provision that is closest to activation at the time of rating assignment, and reflects such assessment on the distance to loss in the notching level.

In the assessment of the distance to activation of the contractual/statutory provisions, JCR (a) first examines the distance to a trigger point based on the trigger level set by contractual provisions; and (b) secondly, in case the distance to the trigger point is assessed to be relatively short (high trigger level), evaluates and adds the possibility of activating the contractual/statutory provisions that could inflict losses.

When the distance to the trigger point were assessed to be "extremely remote" (very low trigger level), the

level of notch-down would be zero (0) as the risk to incur a loss may be extremely small. Likewise, when the trigger were assessed to be pulled at the same time as or extremely close to the issuer's bankruptcy or legal default, then the level of notch-down would be also zero (0).

When the distance to the trigger point were assessed to be "remote" (low trigger level) although it may still take place prior to the issuer's legal default, the level of notch-down would be one (1) so as to stand for the risk that a loss may occur prior to legal default.

When the distance to the trigger point were assessed to be "not remote" (high trigger level), the rating would be notched down but the level of such notch-down would depend on how likely the trigger could activate the contractual/statutory provisions as reaching the trigger point does not necessarily and immediately prompt activation of the contractual provision and result in loss. In judging this likelihood, JCR particularly pays attention to the level of the issuer's discretion in determining the activation of contractual provisions at the time of the trigger point. Specifically, should the issuer be assessed to have considerable discretion, then the level of notch-down would remain one (1). Meanwhile, should the issuer be assessed to have certain discretion while it could likely be constrained by the framework or the authorities' intention, it would be two (2). Should the issuer be assessed to have no or little discretion and the activation is deemed mandatory, it would be three (3).

(2) Assessment of contractual/statutory provisions

A standard notching table, based on the assessment of major contractual/statutory provisions as currently available and their distance to loss, is presented in Table 1 below. This assumes issuers with no material financial weakness.

Table 1: Example of Contractual or Statutory Provisions for Capital Instruments Issued by Financial Institutions and Their Assessment

Assessment of Contractual/statutory provisions (For issuers with no material financial weakness)	Example of Provisions	Standard notch-down due to distance to loss
Very Low Trigger Level	**-Optional suspension of interest payments** (Trigger: Minimum regulatory capital requirement ratio of 1/2) **-Mandatory suspension of principal and/or interest payments** (Trigger: Regulatory capital adequacy ratio at below 120% for securities companies) **-Mandatory write-down/conversion** (Trigger: Point of non-viability (PON), Resolution)	**0**
Low Trigger Level	**-Optional suspension of dividend/interest payments** (Trigger: Shortage in distributable profit) **-Mandatory suspension of principal and/or dividend/interest payments** (Trigger: Shortage in distributable profit) **-Mandatory write-down/conversion** (Trigger: Common Equity Tier 1 (CET1) ratio at below 5.125%)	**1**
High Trigger Level		
Issuer has considerable discretion	**-Optional suspension of dividend/interest payments** (Trigger: Issuer's discretion) (Low constraint over discretion)	**1**
Issuer has certain discretion but likely constrained by system or authorities' intention	**-Optional suspension of dividend/interest payments** (Trigger: Issuer's discretion) (Issuer is subject to regulatory capital buffer requirement)	**2**
No or little issuer discretion and of mandatory nature	**-Mandatory write-down/conversion** (Trigger: Common Equity Tier 1 ratio at below 7.0%)	**3**

Notes (i) When there are a number of contractual/statutory provisions, the level of notch-down is determined based on the provision that has the shortest distance to the trigger point.

(ii) The table shows a standard assessment assuming issuers of no material financial weakness. The notch-down level may vary depending on an issuer's condition and/or legal framework of the operational jurisdiction.

(3) Major contractual/statutory provisions and the distance to loss

(a) Mandatory write-down/conversion (Trigger: PON, Resolution)

This is the case where the contractual/statutory provisions require mandatory write-down of the principal or conversion to equity or other subordinate securities (write-down/conversion) when the issuer is recognized to be at the point of non-viability (PON) or its resolution action is taken by the authorities. In this case, JCR, in principle, does not notch down based on the distance to loss. This is because JCR assumes that such write-down/conversion should take place at the time of undergoing negative equity, payment suspension or in their proximity. JCR's Long-term Issuer Rating normally reflects the distance to those events.

Of course, the conditions where the authorities recognize PON or take resolution actions could differ depending on each country's legal framework. In the case of Japan, we regard that such events happen when one of Resolutions No. 2 and No. 3 of Article 102 and Special Resolution No. 2 of Article 126-2 of the Deposit Insurance Act (DIA, as revised on March 6, 2014) is invoked as per the contents of the DIA and the Ordinance for Enforcement of the DIA. These actions are invoked when the issuer is in negative equity, payment

suspension or in their proximity.

(b) Mandatory write-down/conversion (Trigger: Common Equity Tier 1 ratio at below 5.125%)
This is the case where, among a number of contractual/statutory provisions, the closest to the trigger point is assessed to be the one that requires mandatory write-down/conversion upon the trigger of Common Equity Tier 1 (CET1) ratio at below 5.125% ("low-trigger"). In this case, JCR applies the "notch-down based on the distance to loss" but the notch-down level is limited to one (1). This is because 5.125% of the CET1 ratio is considered to be too low to be tolerated by most issuers or the authorities. It could be natural to assume that issuers strive to constantly maintain their CET1 ratios well above 5.125% and, when it falls sharply, they should take all available measures to restore it with such measures as rights issues and asset disposals. The authorities should also support such issuers' efforts. It may be even reasonable to expect that the government may provide them with precautionary capital injection to help them maintain the CET1 ratio, especially when a precautionary capital injection framework by the government is in place and such injection does not trigger write-down/conversion of various instruments (so called "bail-in"). Therefore, JCR may likely deem that the trigger level of this provision is low and its distance to activation is remote.

(c) Optional suspension of dividend/interest payments (Trigger: Issuer's discretion)
This is the case where issuers can discretionally choose to activate "optional suspension of dividend/interest payments". In this case, JCR applies the "notch-down based on the distance to loss" but its level is also limited to one (1). This is because, although such activation can be made at any time and in such case the distance to the trigger point may not be seen as "remote", issuers, under normal circumstances, do not opt to activate these provisions especially when their discretion is little constrained.

In the case of financial institutions that are highly regulated, however, it may be possible that issuer's discretion to suspend dividend/interest payments is constrained by various regulations or the regulator's intention. For example, JCR sees a greater risk of invoking the "optional suspension of dividend/interest payments" if the issuer is subject to the capital buffer requirement where profit distribution is restricted either partially or entirely in the case when the issuer fails to build a required level of capital buffer.

In the case of Additional Tier 1 capital instruments, discretionary payments for Tier 1 instruments are subject to the restriction of discretionary distribution of earnings under the capital buffer requirement. Therefore, if the capital buffer fell short, there might be a chance of activating the "optional suspension of dividend/interest payments" as a part of such measures. Moreover, even if issuers may have an intention to pay, they may have to suspend them based on the authorities' intention especially when the issuers were severely distressed. Taking into account such risk, JCR applies "notch-down based on the distance to loss" with the level of notch-down at two (2) to those instruments that are constrained by the system or the authorities' intention despite the issuers' nominal discretion. They include Tier 1 instruments of the issuers that are subject to the capital buffer requirement.

That said, the risk of "optional suspension of dividend/interest payments" is not necessarily high merely by

the fact that their issuers are subject to the capital buffer requirement. For instance, in the case of Additional Tier 1 instrument, the issuers are expected to make all efforts to maintain the buffer as a lack of capital buffer could result in severe market pressure. Also, the degree of restriction in profit distribution depends on the severity of capital buffer shortage. Should the level of such shortage be not large, a part of their profit may be allowed to pay out. For example, in Japan, it is only when the CET1 ratio drops as much as near 5% when Global Systemically Important Banks (GSIBs) are restricted to distribute their profit entirely. Also, financial institutions may likely want to keep the order of payment ranking (hierarchy) among their capital instruments. Therefore, at the stage when profit distribution is allowed even partially, they may opt to reduce dividend for common shares so as to continue the full payments of the dividend/interest for Tier 1 capital instruments. This could be particularly plausible if the total amount of dividend/interest for Tier 1 capital instruments remains relatively small. Besides, issuers and the authorities may be cautious to suspend dividend/interest payments as they may consider that such suspension may actually hinder the issuers' capital augmentation as that could push away the investors.

Thad said, we may not always count on the aforementioned cases to happen. It has not been long since the regulations of capital buffer requirement had been introduced. There still remains uncertainty regarding how issuers or the authorities may address actual cases of capital shortages in the future. Of course, issuers are expected to make all available efforts to maintain the buffer. Nevertheless, such needs may occur only if the issuers are under a significant stress, which includes a case when the issuer registers a significant deficit or zero profit. If the profit were nil, such issuer is restricted to pay out entirely including dividend/interest payments for Tier 1 instruments. Such risk needs to be reflected in the notching. Even if the profit were not nil, there is no denying that the authorities may restrict the issuers to make dividend/interest payments in the case of severe stress.

(4) Additional notching adjustment based on the distance to loss

The aforementioned notching levels assume the issuers with no material financial weakness under the current setting. Therefore, JCR may adjust the level of notching depending on the issuer's condition or legal and regulatory frameworks. Their examples are elaborated as follows:

First, adjustment related to the issuer's condition. When there is a provision of mandatory write-down/conversion upon a shortage in distributable profit, the distance to the trigger point is normally assessed to be remote for an issuer with no material financial weakness. However, for an issuer with material financial weakness and with high likelihood of small or depleting distributable profit, such distance may be assessed to be near. Under such circumstances, a mechanical application of the above notching rules may not be able to sufficiently capture the risk of loss in its principal and interest. In such case, the rating may be adjusted based on the distance to loss, which may result in wider notching differences between the ratings on capital instruments and on the issuer's long-term issuer rating.

Second, adjustment related to the legal and regulatory frameworks. When there is a provision of mandatory write-down/conversion upon PON or resolution, no notch-down is normally made. However, notch-down may

be additionally made if (a) there is a risk that write-down/conversion may be enforced prior to the stage of negative equity, payment suspension or in their proximity, and (b) there is a high likelihood or uncertainty for such write-down/conversion to take place. This includes such cases as: (i) a risk of write-down/conversion prior to the stage of negative equity, payment suspension or in their proximity is entailed in the contractual/statutory provisions on the trigger or related laws and regulations; and (ii) a risk of write-down/conversion for precautionary purposes, not just upon resolution, is identified in laws and regulations or the relevant authorities' stance. For instance, the EU's "State Aid Rules" prescribe that, at a time of financial systemic crisis, official capital injection is allowed for a precautionary purpose even to banks that are not regarded as non-viable, but, in principle, that is conditional upon write-down/conversion of hybrid capitals and subordinated debt. Such instruments may be additionally notched-down as they entail a risk of write-down/conversion even prior to a stage of negative equity, payment suspension or in their proximity.

Moreover, when the level of the issuer's Long-term Issuer Rating is low, that rating may incorporate a possibility of government bailout in the future. In such case, that factor may be deducted for the rating on the capital and TLAC instruments. This may result in a wider notching difference from the Long-term Issuer Rating.

6. TLAC Senior Debt

(1) Senior Debt issued by holding companies of GSIBs in Japan

We will apply the same notching rules as described in Sections 3-5 above to TLAC eligible senior debt (TLAC senior debt) to be issued by holding companies of GSIBs in Japan. Basically, the level of notching difference (notch-down) would be zero (0). This is because JCR has the following assumptions about the treatment of such TLAC senior debt in Japan's resolution framework: (a) Loss absorption would be made at the same time as default of general obligations, namely when the issuer undergoes negative equity, payment suspension or in their proximity; and (b) Loss absorption would be made in the process of bankruptcy framework. Therefore, unless any specific clause to define subordination were attached, the ranking of claims of TLAC senior debt would be the same as the issuer's general obligations.

The Japanese authorities are currently preparing to take a single point of entry ("SPE") approach for a TLAC framework for Japan's GSIBs. Losses to be borne at the time of bank resolution will be concentrated to shareholders and creditors of holding companies. Under this scenario, TLAC senior debt is normally issued by a holding company, which will be structurally subordinated to those liabilities that are "excluded to TLAC" as required for TLAC eligibility. By securing such subordination by a characteristic of holding companies, it basically has no contractual/statutory provisions to define such subordination.

In Japan, the DIA defines the "Orderly Resolution" of financial institutions. This provides a framework to make shareholders and creditors bear losses during the bankruptcy process that concurrently proceeds at the time of resolution. In the "Orderly Resolution" framework, the prime minister may, when he/she regards that the financial system stability could be severely disrupted, invoke the Special Resolution No. 2 of Article 126-2 of the DIA to a holding company with negative equity, payment suspension or in their proximity, by which

its liabilities essential to ensure the financial system stability are transferred to a succeeding financial institution and the rest of its liabilities is processed in a bankruptcy framework. In light of the intention of this framework, the TLAC senior debt may not be transferred to the succeeding financial institution. Therefore, assuming a case when the Special Provision No.2 is invoked, the TLAC senior debt may incur a loss as its issuer undergoes negative equity, payment suspension or in their proximity, and the loss amount may be confirmed in the bankruptcy process with an involvement of the court. This is exactly how a loss may be incurred for general obligations which JCR reflects in the Long-term Issuer Rating. Even if the Special Provision No.2 is not invoked, there is no difference in that a loss is incurred when the issuer undergoes negative equity, payment suspension or in their proximity and the loss amount is confirmed through a bankruptcy process. Of course, we may not preclude a possibility that any of Special Resolution No. 2 of Article 126-2 and Resolutions No. 2 or No. 3 of Article 102 is invoked against a deposit taking institution that is a subsidiary of such holding company. In such case, however, that holding company may also likely suffer negative equity, payment suspension or in their proximity, whose senior debt may be processed in the framework of bankruptcy proceeding.

(2) Senior Un-preferred Debt1 issued by banks in the EU

In the EU, not many banking groups adopt a holding company structure. Unlike the Japanese case, TLAC instruments may likely be issued by the banks per se. In such case, however, a framework of structural subordination may not be used. As such, TLAC instruments issued by banks in the EU may likely take a form of "Senior Un-preferred Debt" that has contractual/statutory provisions to make it subordinated to other uncollateralized senior debt in the ranking of claims upon resolution. Senior Un-preferred Debt, eligible for TLAC, has been already introduced in France. Moreover, the European Commission has proposed to incorporate the same framework in the EU's Bank Recovery and Resolution Directive (BRRD). Once the BRRD is amended as proposed, the rest of the EU member states will also be required to apply the amended BRRD framework domestically.

We will apply the same notching rules as described in Sections 3-5 above to the Senior Un-preferred Debt to be issued by banks in the EU. Basically, the level of notching (notch-down) will be one (1). This is because the recoverability of Senior Un-preferred Debt is subordinated to that of other uncollateralized senior debt. Meanwhile, we believe that there is little need to notch down the Senior Un-preferred Debt due to the distance to loss. This is because, (a) write-down/conversion of the Senior Un-preferred Debt is only limited to the time of resolution as per the BRRD, and (b) even when the bail-in is required as per the State Air Rules upon granting a precautionary support (apart from the time of resolution), requirement of write-down/conversion is only limited to hybrid capital and subordinated debt.

7. Standard notching schedule for various capital and TLAC instruments

[1] "Senior Un-preferred Debt" is also called as "Senior Non-preferred Debt". For the sake of consistency, JCR calls it "Senior Un-preferred Debt" in this methodology.

The following tables are the benchmarks of notch-down from the Long-term Issuer Rating for (a) capital and TLAC instruments issued by financial institutions in Japan (Table 2) and (b) capital and TLAC instruments issued by financial institutions in the EU (Table 3), reflecting the aforementioned notching rules based on (a) recoverability and (b) distance to loss.

In the case of instruments issued by holding companies, the notching level in Table 2 is expressed as the difference from the Long-term Issuer Rating of GSIBs' holding companies. The Long-term Issuer Ratings of such holding companies are typically notched down from those of their core banks to reflect their structural subordination deriving from the nature of such holding companies. Therefore, the notching difference between (a) capital and TLAC instruments issued by holding companies of GSIBs in Japan and (b) the Long-term Issuer Rating of their core banks, may be wider than those presented in Table 2.

Table 2: Standard Benchmark of Notching Difference between (a) Capital and TLAC Instruments Issued by Financial Institutions in Japan and (b) their Long-term Issuer Rating

Type of Instruments	Major Contractual/statutory provisions	Standard notch-down level from Long-term Issuer Rating (assuming the issuers with no material financial weakness)
TLAC Eligible Senior Debt (Senior Debt Issued by Holding Company)	-	**0**
Basel II Dated Subordinated Debt	Subordination	**1**
Basel II Perpetual Subordinated Debt	Subordination Optional suspension of interest payment (Trigger: Shortage in distributable profit)	**2**
Basel III Tier 2 Instruments	Subordination Mandatory write-down/conversion (Trigger: PON)	**1**
Basel III Tier 1 Instruments (Tier 1 Instruments by internationally active banks)	Subordination Mandatory suspension of dividend/interest payment (Trigger: Shortage in distributable profit) Mandatory write-down/conversion (Trigger: Common Equity Tier 1 ratio at below 5.125%) Optional suspension of dividend/interest payment (Trigger: Issuer's discretion)	**3**

Notes (i) This is a benchmark for the issuers with no material financial weakness. Assessment may differ depending on each issuer's condition or legal framework.

(ii) Should the Long-term Issuer Rating strongly incorporate a possibility of government bailout in the future, the level of notch-down may be wider than the above as such element will not be reflected in the ratings on capital and TLAC instruments.

(iii) The level of notch-down for Basel III Tier 2 instruments could be wider should the mandatory write-down/conversion be assessed to take place prior to the point of non-viability.

(iv) The level of notch-down for Basel II Perpetual Subordinated Debt and Basel III Tier 1 instruments could be wider should a risk of suspension of dividend/interest payment be assessed high.

Table 3: Standard Benchmark of Notching Difference between (a) Capital and TLAC Instruments Issued by Banks in the EU and (b) their Long-term Issuer Rating

Type of Instruments	Major Contractual/statutory provisions	Standard notch-down level from Long-term Issuer Rating (assuming the issuers with no material financial weakness)
TLAC Eligible Senior Debt (Senior Un-preferred Debt)	Subordination Mandatory write-down/conversion (Trigger: Resolution)	**1**
Basel III Tier 2 Instruments	Subordination Mandatory write-down/conversion (Trigger: PON, Resolution)	**2**
Basel III Tier 1 Instruments	Subordination Mandatory suspension of dividend/interest payment (Trigger: Shortage in distributable profit) Mandatory write-down/conversion (Trigger: Common Equity Tier 1 ratio at below 5.125%) Optional suspension of dividend/interest payment (Trigger: Issuer's discretion)	**4**

Notes (i) This is a benchmark for the issuers with no material financial weakness. Assessment may differ depending on each issuer's conditions, legal framework, etc.

(ii) Should the Long-term Issuer Rating strongly incorporate a possibility of government bailout in the future, the level of notch-down may be wider than the above as such element will not be reflected in the ratings on capital and TLAC instruments.

(iii) The level of notch-down for Basel III Tier 1 instruments could be wider should a risk of suspension of dividend/interest payment be assessed high.

8. Insurance Companies and Insurance Holding Companies' Capital Instruments

Under economic value-based solvency regulations, an insurance company's regulatory eligible capital is categorized into: Tier 1 capital without limits on inclusion; Tier 1 capital with limits on inclusion (Tier 1 limited capital); paid-in Tier 2 capital; and unpaid Tier 2 capital.

JCR determines a rating notch for insurance companies' and insurance holding companies' capital instruments in consideration of both the subordination clause and the distance to loss. For bonds and similar instruments counted as Tier 1 limited capital, we view that both the subordination clause and the distance to loss are taken into consideration in many cases. For bonds and similar instruments counted as Tier 2 capital, the same basic perspective applies; however, if loss absorption upon company liquidation is explicitly stated and the loss trigger level determined from contract terms is judged to be extremely low, there is little need to consider notching based on the distance to loss. For bonds and similar instruments issued by structurally subordinated insurance holding companies, such as holding company senior bonds, which are counted as Tier 2 capital, the bond rating, in principle, is not notched down from the long-term issuer rating. That said, if the insurance holding company's long-term issuer rating is A- or lower, the bond rating is notched down from the long-term issuer rating in consideration of contractual terms and other factors.

Funds as a financing method unique to mutual companies are subordinated in term of the distribution of residual assets during company liquidation. Moreover, even though Article 55 of the Insurance Business Act sets maximum limits on principal and interest payments, leaving the possibility of deferral in the event of a shortfall, the likelihood of this actually occurring is extremely low. Hence, the rating for funds is basically assigned one notch below the long-term issuer rating.

Table 4 provides guidelines for notching from the long-term issuer rating for each type of capital instruments.

Table 4: Guidelines for Notching from the Long-Term Issuer Rating for Ratings Assigned to Capital Instruments Issued by Japanese Insurance Companies and Insurance Holding Companies

Type of Instruments	Standard notch-down level from Long-term Issuer Rating (assuming the issuers with no material financial weakness)
Tier 1 instruments with limits on inclusion (Tier 1 limited instruments)	**2**
Paid-in/Unpaid Tier 2 instruments	**2**
In cases where the loss trigger level determined from contract terms is judged to be extremely low	**1**
Senior bonds and similar instruments issued by insurance holding companies	**0**
In cases where insurance holding companies with the long-term issuer rating of A- or lower issue instruments with a lock-in clause	**1**
Funds issued by mutual companies	**1**

Note: This is a benchmark for the issuers with no material financial weakness. Assessment may differ depending on each issuer's condition, legal framework, etc.

Japan Credit Rating Agency, Ltd.
Jiji Press Building, 5-15-8 Ginza,
Chuo-ku, Tokyo 104-0061, Japan
Tel. +81 3 3544 7013, Fax. +81 3 3544 7026