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Revision of “Rating Methodology for Assessment of Hybrid Securities’ Equity Content”

Japan Credit Rating Agency, Ltd. (JCR) hereby announces that it has revised the "Rating Methodology for Assessment of Hybrid Securities’ Equity Content.”

JCR revised the rating methodology as a result of considerations that were announced in its press release "JCR Solicits Public Comments on Revisions to ‘Rating Methodology for Assessment of Hybrid Securities’ Equity Content’" dated October 14, 2022. JCR revised the rating methodology after making some modifications to the proposal presented at the time of the request for the public comments for clarification. There are no changes in the long-term issuer ratings and ratings on individual bonds, etc. due to the revisions to the equity content assessments associated with this rating methodology revision (see JCR's press release 22-D-1044 dated today).

The revised rating methodology will be posted on the "Rating Methodologies: Corporates" page (https://www.jcr.co.jp/en/rrinfo/meth_corp/) and "Rating Methodologies: Financial Institutions" page (https://www.jcr.co.jp/en/rrinfo/meth_finance/) of JCR's website.

In the request for the public comments, there were several inquiries as to how individual product characteristics will be handled in the future. In light of the interest of investors and rating stakeholders, going forward, JCR will make an effort to provide specific and detailed explanations in press releases, comments, etc.

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Rating Methodology for Assessment of Hybrid Securities' Equity Content

1. Hybrid Securities and Equity Content

Hybrid securities (or hybrids) are the financial instruments that have the characteristics of both equity and debt. They take various forms such as subordinated bond, subordinated loan, preferred securities, and preferred stock. In this methodology, they are collectively called as "hybrid securities," covering not only securities but also loans. Hybrid securities are different from common stock in that they may have a fixed redemption date or a scheme to step up interest/dividend rates. Meanwhile, they also have equity-like characteristics such as flexibility over cash payouts or priority of claims upon bankruptcy. For example, they may have (a) a suspension clause – to allow suspension of interest, dividend or even principal payments without triggering default (i.e., non-fulfilment of debt obligations, or non-payment against contractual terms) when certain conditions are met, or (b) a subordination clause – to make them subordinated to senior debt in terms of priority of claims upon bankruptcy. In assessing the equity content of hybrid securities, JCR looks into these characteristics and evaluates how close such hybrids are to common stock.

2. Framework of Equity Content Assessment

(1) Scale of Equity Content - Five Levels

To express the degree of hybrid securities' equity content, JCR adopts a five-level scale (Table 1): "Equivalent to stock/100%," "High/75%," "Medium/50%," "Low/25%," and "Equivalent to debt/0%." These percentages indicates the degree of equity-like characteristics for which 100% is assigned to common stocks. These percentages correspond to JCR's equity calculation of hybrid securities in our financial analysis. In other words, these ratios are used as a benchmark to count the amount of equity out of hybrid securities' principal when JCR calculates various quantitative analytical figures in our analysis of issuers' long-term issuer rating. For example, subordinated debt of JPY100 billion with equity content of High/75% is deemed to have JPY75 billion (75% of principal) of equity, and JPY25 billion (25% of principal) of debt, respectively. Such quantitative analytical figures are normally analytical indicators such as capital adequacy ratio or debt-equity ratio, which is calculated using equity amount and debt amount.

Table 1: Scale of Equity Content

Equity Content	Ratio of Equity Calculation (%)
Equivalent to stock / 100%	100
High / 75%	75
Medium / 50%	50
Low / 25%	25
Equivalent to debt / 0%	0

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(2) Three Key Characteristics of Equity Content

Assessment of hybrid securities' equity content is to see their proximity to common stock from the perspective of credit analysis. In the view of creditors, common stock acts, through the following two functions, to enhance the certainty of debt payments: (a) it may reduce a chance of issuers' default by restraining cash payouts when stressed, which may underpin their financial flexibility or stability; and (b) it may improve recoverability of debt (or credit from creditors' viewpoint) by providing a buffer to absorb losses when stressed.

Of the two above, the first function to restrain cash payouts may derive from the common stock's characteristic as (i) no principal redemption or maturity is set and (ii) there is no obligation to pay interest/dividend. The second function to provide a buffer to absorb losses may derive from its characteristic as (iii) having the least priority of claims upon bankruptcy. JCR views these three as key characteristics of equity content. When assessing individual securities' equity content, we will measure the degree of these characteristics.

Table 2: Key Characteristics for Equity Content

	Key Characteristics for Equity Content	Functions	Related Provisions in Hybrid Securities
1	**[Permanence of Principal]** No fixed principal redemption or maturity	To underpin financial flexibility and stability by alleviating repayment pressure or refinancing risk	-Redemption -Call -Interest/dividend step-up -Replacement language -Conversion into common stock -Capital reduction
2	**[Flexibility of Interest Payment]** No interest/dividend payment obligation, and no accumulation of forgone interest/dividend	To underpin financial flexibility and stability by restraining cash payouts when stressed.	-Suspension of interest/dividend payment (mandatory or optional) -Accumulation or non-accumulation -Mandatory payment -Events of default
3	**[Subordination]** Least priority of claims upon bankruptcy	To improve debt recoverability upon bankruptcy	-Distribution of residual asset -Subordination

3. Characteristic 1: Permanence of Principal

(1) Overview

With no redemption obligation and maturity in place and, consequently, weaker pressure on cash payouts, common stock is equipped with the function to underpin issuers' cash flow flexibility and stability. When JCR evaluates the permanence of principal, we see how much this characteristic is attached. Among the three characteristics of equity content as described above, JCR gives the heaviest weight on this permanence of principal given that many corporate bankruptcies have been driven by cash flow difficulties. The permanence of principal is gauged by a scale of three levels – "Strong," "Moderate" and "Weak."

The permanence of principal is evaluated not by just whether the securities exist permanently, but by whether or not their maturity is sufficiently long and issuers' discretion over redemption is sufficiently high. Many hybrid securities are actually designed to encourage issuers to redeem their principal early with such schemes as call (to repay early upon issuers' discretion) or step-up of interest/dividend rates. Therefore, in this assessment, we look

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into whether there is any element that practically and materially constrains issuers' discretion over redemption, and its effectiveness. It would be important that such scheme is designed to accommodate issuers' control over cash payouts and allow the principal to be preserved when needed.

The framework of assessment and its benchmark are illustrated below (Table 3). There are four elements to evaluate the permanence of principal. First, we assess the remaining length to legal maturity in a scale of three levels. After that, adjustment is made by taking into account the rest of the three elements before reaching the conclusion. As seen, the first three elements are basically judged by the clauses attached to the securities while the fourth element takes into account qualitative aspects which may include situations where issuers are placed and their financial management policy.

Table 3: Benchmark for Assessing the Permanence of Principal

		Elements	Major provisions	Assessment and Adjustment
+	Step 1	Legal redemption obligation	Maturity (remaining maturity) -Perpetual or > 30 years: S ->20 years: M ->10 years: W -Near-term mandatory conversion: S	Strong (S) Moderate (M) Weak (W)
-	Step 2	Elements that may shorten the remaining maturity by call	Call Provision (No interest/dividend rates step-up)	-1 (e.g. S→M)
			Call Provision & Interest/dividend rates step-up	-2 (e.g. S→W) (However, if the period from the issue date to the first callable date is 10 years or longer, the downgrade will be limited to one notch until the first callable date.)
			Call Provision & Limited interest/dividend rates step-up	-1 (e.g. S→M)
+	Step 3	Elements that may increase the chance of refinancing when called	-Issuer's valid expression of intent for replacement financing -Need of the authorities' approval for redemption -Constituting as core capital under regulatory or accounting framework	+1 (e.g. W→M) (N.B. when there is a call provision)
+/-	Step 4	Any other elements that may affect flexibility or discretion (for final judgment)	Other provisions, Content of intent for replacement financing, Regulator's redemption policy, Situation where issuers are placed, Issuer's financial management policy, nature of securities holders, Financing cost of securities, etc.	As needed
	Final Step	Steps 1-4	-	S / M / W

Take, for example, one hybrid securities with (a) 40 years of remaining maturity, (b) a provision to activate a call option with interest rate step-up by 100 basis points (1.00%) after five years from issuance, and (c) the issuer's valid expression of intent for replacement financing. In this case, (i) in Step 1, it is provisionally assessed as "Strong" given that the remaining maturity is longer than 30 years, (ii) in Step 2, it is downgraded by two notches to "Weak" as the long maturity may be shortened due to the call and step-up provisions, and (iii) in Step 3, it is upgraded by one notch to "Moderate" given the issuer has validly expressed intent for replacement financing. Should there be

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no additional adjustment made in Step 4 over other elements, the final judgment would be “Moderate.”

(2) Legal Maturity

The timing of first call or step-up, which incentivizes redemption, may be widely viewed as “effective maturity” of hybrid securities in the market, which may be useful to know in measuring the risk of such securities. That said, principal redemption at such “effective maturity” is not a legal obligation so ultimately, despite practical constraint, it is up to the discretion of issuers. In view of avoiding defaults or securing stable financials and cash flows, it would be paramount that sufficient time is left till legally obliged principal redemption date. Therefore, when evaluating the permanence of principal, JCR starts by examining whether or not there remains a sufficiently long period till “legal maturity” when the principal redemption is legally obliged.

After the issuance, when the remaining period till legal maturity becomes shorter surpassing a certain threshold shown in step1 of table 3, we consider lowering the evaluation on permanence. We take into various elements including issuers’ financial management policy to conclude our judgement.

(3) Call, Interest/Dividend Step-up

When hybrid securities contain provisions of both call option and coupon step-up, market participants may tend to implicitly assume that such call option would be exercised in accordance with market practices and pricing of such securities may be determined on that assumption. Therefore, issuers who dare not to exercise the call option may be criticized for not meeting the expectation of hybrid securities investors. Such issuer may even be commercially penalized by undergoing a temporary difficulty in fundraising in the capital market. As such, issuers’ discretion over redemption may be, in practice, significantly constrained should issuers aim to stave off these criticism or penalty.

Forms of call and step-up schemes may vary. Our evaluation focuses on how such step-up could significantly constrain the discretion over redemption which issuers literally have. There could be different schemes, other than step-up, that could increase issuers’ economic burden passing a certain period, which we evaluate in the same way as that on step-up.

JCR understands that many step-up products are designed to have a step-up level at 100bp, which may be the market standard of today. Should the step-up level be much lower than the standard, hybrids investors’ expectation for call exercise may be limited, which may give issuers greater discretion over redemption. Therefore, when the step-up level is much lower than the standard, say 30bp, JCR may consider treating it as if there were no step-up provision. On the other hand, when the step-up level is much higher than the standard such as 200bp, JCR may lower the evaluation as it may mean that issuers may be less determined to exercise its discretion over redemption.

In the case of sequential step-up provisions, we would treat it as if there were no step-up provision until it cumulatively reaches to the level that is considered as significantly constraining issuers’ discretion over redemption. If such period were extremely long, we would raise the evaluation on permanence. Take, for example, securities callable after 5 years with 20bp step-up after 5 years and 80bp after 25 years (cumulative 100bp (20+80)). We may view that issuers have solid discretion over redemption in such case.

The range of step-up levels that could affect the equity content assessment may vary depending on issuers’

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condition or market environment. For example, assume an issuer with "BB range" long-term issuer rating that is faced with high funding cost in absolute terms and strong need to continue relying on equity-like funding. In such case, even if the step-up level is set at much higher than the standard, say 200bp, it may be deemed that it would likely opt to use discretion over redemption not to call. We may not lower our evaluation due to the step-up level in such case.

For the securities with a call but no step-up provisions, the likelihood of exercising call may depend upon issuers' financial condition or financial management policy, or investors' expectation for call. While the permanence of principal for such securities may be evaluated as generally weaker than those without a call provision, the evaluation may not be mechanical, taking into account individual cases greatly.

On the call provision, the current practice is to set the period between the issue date and the first call to about between 5 and 10 years in many cases. If that period is shorter, such as three years, JCR may deem that issuers may be determined to redeem early and, therefore, may lower the evaluation. On the other hand, a longer time to first call indicates that the issuers are seeking longer-term stable capital and have relatively less willingness to redeem. This is a factor that supports the strong stance taken by the issuers to ensure financial soundness. JCR considers that if the period until the first call is 10 years or longer, the issuers' discretion over redemption can be secured to a certain extent, and will reflect it in the evaluation of permanence under certain conditions.

(4) Intent for replacement financing

The issuers of hybrid securities with a scheme to encourage call, such as step-up, often express their intent not to call unless they are able to replace them with securities with the same or higher degree of equity content. Should such intent for replacement be considered valid in terms of content and likelihood, we may view that issuers have solid discretion over redemption and, therefore, the permanence of securities may be assured when needed by issuers.

Outside Japan, there are cases where future replacement is legally bound and creditors such as senior debt holders are entitled to enforce the issuers to observe it. Meanwhile, in Japan, such intent is usually expressed only in prospectus, not in legally-binding contracts. In this case, creditors do not have a legal right to enforce issuers to fulfil the stated intent. That said, for those issuers with their stocks listed in the market or their bonds issued publicly, market players' confidence may matter. In such case, we believe that the intent expressed in prospectus may have a significant meaning so deem it valid.

Whether there is a language to express the intent for replacement financing, or replacement language, in securities' prospectus, contract, attachment to contract, investor material, press release or any other documents, may provide an important clue in evaluating how likely the call could be exercised without replacement. Should there be any technical or special reason not to be able to state such intent in documents and such reason be deemed reasonable, we may assess that there may be a high likelihood of having replacement financing.

We believe that it would be desirable that the amount of replacement issue be equal to that of the principal to be redeemed. Meanwhile, there is a replacement language that focuses on the equity content (the amount that is calculated as equity in financial analysis). This may define that the replacement is deemed to be made if the same

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amount of equity content is replaced and even if the issue amount per se is smaller than the redeemed principal. JCR views that such replacement language based on the equity content may also be valid, though weaker than that amount-based replacement. This is because, while various financial ratios used for rating analysis may be maintained even after the replacement, this may work negatively in terms of cash flow flexibility and stability as the difference, should the issue amount be smaller than the redeemed amount, may be paid out on a net basis. Therefore, we carefully assess the scheme, especially whether issuers are aware of this cash payout impact and, therefore, call would be exercised in a cautious manner.

In our view, capital increase as a result of conversion of convertible bonds into common stock may be included as replacement financing defined in the replacement language. This is because this may, not only augment the amount of equity in rating analysis, but also enhance the cash flow flexibility and stability as the redemption obligation would be extinguished, having a similar impact of issuing new securities of the same or even higher equity content.

At times, a curve-out clause may be found in the replacement language. This is to regard fulfilment of certain condition (e.g., increase in net worth) as a substitute to replacement financing and, hence, exceptionally allow call without replacement. In this case, should the condition be met, the pressure for call may mount even if issuers are under stress. Therefore, it may be difficult to assess "Strong" for the permanence of principal on such securities with a curve-out clause – unless the conditions for curve-out are defined extremely strict. Also, to earn "Moderate" assessment, keeping the financial strength which is observed at the issuance of the security by increasing the same amount of net worth as the principal amount is necessary at a minimum. For some issuers, improvement in financial strength is necessary. This is because long-term issuer ratings often assume certain improvement of financial status in the future. Therefore, should there be a curve-out clause with just keeping the financial strength which is observed at the issuance of the security as a condition to dispense replacement financing, we would carefully look into issuers' financial status as well as financial management policy including whether they would carefully exercise call, and reflect them in the assessment.

Regardless of the existence of replacement language, JCR interviews with issuers for their financial management policies so as to judge the likelihood of call without replacement. We make deliberation whether the financial management policy explained by issuers is persuasive and consistent with their financial status including the level of capital and funding structure.

(5) Authorities' Policy for Approving Redemption

In the cases of banking or other sectors that are subject to capital adequacy regulations, hybrid securities' call may often be conditioned upon the authorities' approval. JCR may treat such securities in the same manner as those with replacement language, given that the permanence of securities may be respected when needed by issuers. In such case, JCR looks into how the authorities view issuers' adequate capital level, and correlations between the indicators the authorities refer to when approving such call and stresses faced by the issuer. If it were deemed that redemption without replacement could be easily approved, we would not treat it in the same way as that with replacement language.

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(6) Constitution as Core Capital under Regulatory or Accounting Framework

JCR may raise the evaluation if securities are constituted as core capital under regulatory or accounting framework, such as “Capital” defined in IFRS (International Financial Reporting Standard) or “Common Equity Tier 1 Capital” under banks’ capital adequacy regulations. This is because this may give incentives for issuers to be more cautious to redeem principal. That said, the fact that they are core capital does not automatically lead to regarding such securities as capital or assessing such securities as having higher permanence of principal. For example, preferred stock with put option constitutes capital under accounting rules but we view it with very low equity content. Thus, constitution as core capital may lead to higher evaluation, but only if the likelihood of future replacement is judged to be enhanced.

(7) Put Option

JCR believes that put option, which entitles investors to redeem principal, would greatly undermine the equity content. To qualify for equity content, it would be necessary that: (a) issuers would retain the discretion over redemption and (b) permanence of securities is assured when and if issuers need.

(8) Change of Control

Some hybrid securities have a scheme that their principal would be redeemed if control through stock-holding is changed such as by takeovers. Should it be triggered by issuers’ discretionary call, JCR would not see that the permanence of principal is largely undermined – even if it entails significant coupon step-up. This is because a change of control is a kind of event risk, which is normally not taken into account in rating analysis as well.

However, if it could be triggered by investors’ put, then we would lower the evaluation. This is because, even though such change of control is rather an event risk, the obligation to redeem could significantly undermine issuers’ financial flexibility. Even in comparison with common stock, although companies may buy back their own stock after a change of control, it is purely based on their own discretion, not obligation.

(9) Conversion to Common Equity

Once securities are converted to common stock, there will be no more maturity and obligation to redeem. Therefore, mandatory convertible securities with less than three years of stipulated duration to mandatory conversion may have a very high likelihood of conversion to common stock and, hence, may be given high evaluation for such scheme. Some issuers may, in order to avoid stock dilution or changes in stockholders’ composition, attempt to call prior to conversion. In such case, we may need to see as if issuers’ discretion over redemption were effectively impaired. Therefore, in order for us to give high evaluation, we may need to confirm that: (a) there is no concern over significant stock dilution and changes in shareholders’ composition which the issuer may try to avoid; and (b) issuers are judged to manage their financials on a clear acceptance and assumption of their future conversion to common stock.

If conversion to common stock is defined as investors’ discretion like convertible bonds, we may not basically

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view them as contributing to equity content. This is because, although conversion may not be precluded if conversion price is significantly lower than stock prices, stock prices may vary and conversion remains solely up to the investors' will.

(10) Others

The assessment of the permanence of principal is conducted by looking into not only contractual provisions but also other various elements. JCR believes that it would be very important to reflect the situation in which issuers are placed or their financial management policy given that hybrid securities may work upon issuers' discretion. As such, assessment result, even for securities with the same contractual provisions, may vary depending on their issuers.

For example, JCR may, even on hybrid securities with replacement language, downgrade our evaluation if, as a result of analyzing issuers' circumstances and financial management policy, it is deemed that, at the time of stress, it may likely call without replacement. Meanwhile, JCR may upgrade our evaluation if, in the presence of issuers' strong will or decisive economic incentive, it is deemed that, even at the time of stress, it may unlikely call without replacement.

4. Characteristic 2: Flexibility of Interest Payment

(1) Overview

In the case of common stock, distribution of surplus funds including dividends is normally regulated by law (e.g., the Companies Act in Japan). When such distributable funds are depleted, dividend payouts are forced to be suspended or reduced. Even if it is not depleted, issuers may discretionally suspend or reduce dividend payments. Non-payment of dividends would not constitute legal default (i.e., non-payment against contractual terms). Therefore, when we assess hybrid securities in terms of their flexibility of interest payment, we would look into how much such securities have these common stock's characteristics over dividend payments, namely whether (i) it could financially avoid default (financial flexibility) by discretionally restricting cash payouts even at a stage when issuers are not much stressed; and (ii) it could legally avoid default given that non-payment would not constitute default. This assessment for the flexibility of interest payment would be, like the permanence of principal, assessed in a scale of three levels – "Strong," "Moderate" and "Weak."

The benchmark of assessing the flexibility of interest payment is summarized below (Table 4). Key issues may be (a) whether they have provisions of optional or mandatory suspension and (b) whether such forgone interest/dividend(s) are accumulated or not. As in the case of the permanence of principal, we not just analyze contractual provisions, but take into account other elements as well to conclude our judgment. For example, when we judge that the issuer may continue paying interests even when stressed in light of the investors' very strong pressure, we may lower our evaluation of the security to "Weak" or below even if it is evaluated as "Moderate" based on contractual provisions.

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Table 4: Benchmark for Assessing the Flexibility of Interest Payment

Optional Suspension	Mandatory Suspension	Cumulative/ Non-cumulative	Assessment
No	No	-	Equivalent to debt
Yes	No	Cumulative/Non-cumulative/ACSM1/	Weak
No	Yes	Cumulative/Non-cumulative/ACSM1/	Weak or Moderate
Yes	Yes	Optional suspension: Cumulative Mandatory suspension: Cumulative	Moderate
Yes	Yes Low Trigger	Optional suspension: Cumulative Mandatory suspension: Non-cumulative/ACSM1/	Moderate
Yes	Yes High Trigger	Optional suspension: Cumulative Mandatory suspension: Non-cumulative/ACSM1/	Strong

(2) Optional Suspension and Mandatory Suspension

Many hybrid securities have provisions to suspend interest/dividend payments, under which such suspension would not constitute default. Nevertheless, many hybrid securities' investors actually expect continuous and stable payments of interest/dividend. As such, issuers tend to adhere to paying interest/dividend unless they are significantly stressed as non-payment may undermine the investors' confidence and, therefore, adversely affect their future fundraising. Therefore, having this suspension clause per se may not always warrant financial flexibility (for avoiding default).

To secure the flexibility of interest payment, it would be desirable to have both optional and mandatory suspension clauses. This is because, if securities have only optional suspension clause whose exercise is issuers' discretion, issuers may well continue paying interest/dividend even when distributable funds for common stock are depleted and no dividend is paid for stockholders. If securities have a scheme in which non-payment has disincentive such as giving voting rights to preferred stockholders upon non-payments, our evaluation may be further lowered.

(3) Trigger for Suspension

In order to give positive assessment to mandatory suspension, the trigger for suspension ought to be set at an appropriate level. Such trigger needs to be invoked at a fairly early stage before issuers' debt is defaulted. For example, cash payouts may need to be restricted at latest when distributable funds for common stock are depleted.

We are of the view that, when the trigger is linked to regulatory indicators such as life insurance companies' solvency margin ratio, it has to be fixed at a level significantly higher than the minimum regulatory ratio. This is because, when those ratios come down close to the minimum ratio, market confidence for, hence creditworthiness of such regulated entity should have significantly deteriorated, which may not be considered as "fairly early before default."

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(4) Cumulative, Non-cumulative, ACSM

To secure the flexibility of interest payment, it would be desirable that interest/dividend, once suspended, not be accumulated (i.e. non-cumulative), namely whose payment will not be obligated in the future. If accumulated (i.e. cumulative) where suspended payments will need to be paid once certain criteria is met, issuers' incentive to suspend (as they will need to pay in the future) may be low and future cash payout may not be precluded. As such, our evaluation for "cumulative" would be lower than that for "non-cumulative."

Some hybrid securities have a scheme where only the proceeds of hybrid securities or other securities with the same or higher equity content can be allocated to the funds to pay for accumulated non-paid interest/dividend. This scheme is called "Alternative Coupon Satisfaction Mechanism (ACSM)." We view the ACSM as having nearly the same effect as "non-cumulative" in terms of holding off the suspended interest/dividend payments. That said, this would require future issuance of common stock or securities with equity content if interest/dividend payments were suspended, which may make issuers reluctant to suspend hybrid securities' interest/dividend payments as that could dilute stocks or impose technical burden. Therefore, we would cautiously analyze such securities especially if we consider assessing as "Adequate" or above.

(5) Mandatory Payment Clause (or Look-back, Dividend-pusher)

Mandatory payment clause is defined to make it mandatory to pay interest/dividend if certain event occurred in the past. This may be sometimes called as "Look-back clause" or "Dividend-pusher." A typical case is that, if dividend is paid to common stock holders in one year (e.g., FY2021 (i.e., between April 2021 and March 2022)), interest must be paid to hybrid securities holders in the following year (e.g., FY2022, due in September 2022 and March 2023) even if suspension trigger is infringed. For example, if an interim dividend is paid to common stock holders in July 2021, interest on hybrid securities during FY2022 must be paid including those due in March 2023. In this case, in order to suspend the hybrid securities' interest payment in March 2023, interim dividend in July 2021, 20 months prior to March 2023, must have been suspended. As seen in this case, if payments of interest/dividend are restricted by an event having occurred more than one year ago including those based on mandatory suspension clause, we would have lower evaluation on the flexibility of interest payment than in other cases.

5. Characteristic 3: Subordination upon Bankruptcy

(1) Overview

Common stock has the least priority in terms of claims upon bankruptcy, acting a role (of subordination) to uplift "recoverability of debt obligations" upon default. When we assess the hybrid securities on its subordination upon bankruptcy, we look into how much such function is provided in a scale of two levels: "Moderate" and "Weak."

We treat this subordination assessment as secondary to those on the permanence of principal and the flexibility of interest payment. This is because the assessment of hybrid securities' equity content is aimed at facilitating the analysis of issuers' certainty to fulfil debt obligations, which would principally depend on whether the issuers could continue generating sufficient cash flow without going into bankruptcy. Therefore, it may not be very relevant to

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focus too much on the recoverability upon bankruptcy in the analysis of debt payment capacity. Likewise, it may not be very relevant to put great emphasis on the recoverability upon bankruptcy in the assessment of hybrid securities' equity content, unless issuers have very low credit profile.

(2) Subordination Clause

The scheme to ensure subordination is normally defined in subordination clause. In assessing the subordination, what matters is hybrid securities' ranking vis-à-vis general debt, not the relative ranking vis-à-vis preferred stock which does not bring much difference in our assessment. As below (Table 5), we evaluate it as "Moderate" if there is no other debt that is further subordinated to hybrid securities, and "Weak" if there is.

Table 5: Assessment of Subordination

Priority of claims upon bankruptcy	Assessment
With no further subordinated debt	Moderate
With further subordinated debt	Weak

The assessment of subordination is conducted on the basis of entities for which outcome of our assessment on their equity content is incorporated in our financial analysis. For example, assume that one company issues hybrid securities through its SPC subsidiary. In order for us to apply the equity content of such securities to our financial analysis of that company, a scheme is required to make such securities be subordinated to other debt of that company, not just other debt of the SPC.

6. Overall Assessment

Based on the three characteristics as explained above, combined with other factors, we assess hybrid securities' equity content. The benchmark is represented below (Table 6). Among the three characteristics (i.e., permanence of principal, flexibility of interest payment, and subordination upon bankruptcy), we attach the heaviest weight to the permanence of principal.

Table 6: Benchmark for Assessment of Equity Content

		Flexibility of Interest Payment		
		Weak	Moderate	Strong
Permanence of Principal	Weak	Low/25%	Low/25%	Low/25%
	Moderate	Medium/50%	Medium/50%	Medium/50% or High/75%
	Strong	Medium/50%	High/75%	High/75%

The table above illustrates the case when the evaluation of subordination is "Moderate." If that evaluation were "Weak," such securities' equity content would not be, in general, assessed as higher than "Weak/25%" regardless of the assessment on the permanence of principal and the flexibility of interest payment.

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