

## **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
<b>Very Low Trigger Level</b>	<p><b>-Optional suspension of interest payments</b> (Trigger: Minimum regulatory capital requirement ratio of 1/2)</p> <p><b>-Mandatory suspension of principal and/or interest payments</b> (Trigger: Regulatory capital adequacy ratio at below 120% for securities companies)</p> <p><b>-Mandatory write-down/conversion</b> (Trigger: Point of non-viability (PON), Resolution)</p>	<b>0</b>
<b>Low Trigger Level</b>	<p><b>-Optional suspension of dividend/interest payments</b> (Trigger: Shortage in distributable profit)</p> <p><b>-Mandatory suspension of principal and/or dividend/interest payments</b> (Trigger: Shortage in distributable profit)</p> <p><b>-Mandatory write-down/conversion</b> (Trigger: Common Equity Tier 1 (CET1) ratio at below 5.125%)</p>	<b>1</b>
<b>High Trigger Level</b>		
Issuer has considerable discretion	<p><b>-Optional suspension of dividend/interest payments</b> (Trigger: Issuer's discretion) (Low constraint over discretion)</p>	<b>1</b>
Issuer has certain discretion but likely constrained by system or authorities' intention	<p><b>-Optional suspension of dividend/interest payments</b> (Trigger: Issuer's discretion) (Issuer is subject to regulatory capital buffer requirement)</p>	<b>2</b>
No or little issuer discretion and of mandatory nature	<p><b>-Mandatory write-down/conversion</b> (Trigger: Common Equity Tier 1 ratio at below 7.0%)</p>	<b>3</b>

- 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.

That 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 Debt<sup>1</sup> issued by banks in the EU

In the EU, not many banking groups adopt a holding company structure. Unlike the Japanese case, TLAC instruments are often 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 in many cases 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.

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

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)

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<sup>1</sup> “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.

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 sometimes notched down from those of their core banks to reflect their structural subordination deriving from the nature of such holding companies. In such case, 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 is 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 (see Note (ii) below)	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
Notes (i) This is a benchmark for the issuers with no material financial weakness. Assessment may differ depending on each issuer's condition, legal framework, etc.	
(ii) This assumes a product with the subordination clause and mandatory interest payment deferral clause (trigger: ESR of 100%) but without the optional interest payment deferral clause. The notching difference when the optional interest payment deferral clause is also included, in principle, is two (2).	

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