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# Rating and Evaluation on Equity Content of Tier 2 Instruments Eligible under Basel III

Japan Credit Rating Agency, Ltd. (JCR) has modified a part of rating methodology for Tier 2 instruments eligible under Basel III ("B3T2 instruments"). As a result of considering modifying the rating methodology that was announced on February 17, 2014 in its press release of "JCR Considers Modifying Rating Methodology for Tier 2 Instruments Eligible under Basel III," JCR decided to modify its rating methodology for the instruments as described in the modification plan in the press release of February 17, 2014. There will be no changes to the individual ratings assigned by JCR owing to the modifications to this rating methodology. Content of this press release is a revision of that of "Rating and Evaluation on Equity Content of Tier II Contingent Capital Instruments Eligible under Basel III" published by JCR on November 17, 2011 and supersedes the latter document.

## 1. Tier 2 Instruments Eligible under Basel III

B3T2 instruments are contingent capital instruments that are converted into lower ranking securities such as stock or written off (hereinafter referred to as "write-off/conversion") on a mandatory basis when they touch specific triggers (certain trigger events occurred).

B3T2 instruments are required to meet minimum requirements to ensure loss absorbency at the point of non-viability or PON. Contract provisions or laws and ordinances need to be arranged so that write-off/conversion can be forced when the relevant authority decides that the issuer is at the point of non-viability. These requirements have been established, learning from the past experiences in the financial crises that Tier 2 instruments did not play a role as gone-concern capital which absorbs loss when failure takes place despite occurrence of burden on taxpayers including injection of public sector capital.

Under Basel III regulations in Japan, it is required that B3T2 instruments in principle include a point of non-viability clause ("PON Clause") that provides for the instruments' write-off/conversion when the issuer reaches at the point of non-viability or PON.

## 2. JCR's Policy for initiating Rating

### (1) Principle

JCR does not assign a rating in principle for any contingent capital instruments including B3T2 instruments in cases where such instruments are deemed to have factors which make it difficult for JCR to decide existence of infringement of a trigger or evaluate a probability of such infringement. Specifically, JCR does not assign a rating in such cases as the following: (i) In cases where terms and content of description for the trigger provisions are extremely unclear; (ii) In cases where discretions of persons other than the issuer (including the relevant authority) are used for a trigger and it is considered extremely difficult to foresee attitudes for exercise of their discretions of such persons other than the issuer; (iii) In cases where factors directly unrelated to creditworthiness of the issuer such as stock price are used for a trigger; and (iv) In cases where a rating (including a rating of other than JCR) is used for a trigger.

In determination of ratings, JCR will engage in measuring distance to the occurrence of write-off/conversion which causes loss to investors for the rated instruments. Measurement of the distance will become extremely difficult when the instruments come under the cases (i) through (iii) above. As for the (iv) above, there is no problem with the points that a rating is related to creditworthiness of the issuer and that it is a very clear indicator. However, in cases where a JCR's rating is used for a trigger, JCR will "forecast transitions of self-determined rating and perform rating based on it," which is self-referring and cyclical work as a result. Furthermore, should a rating agency directly trigger an event to determine a level of rating, its status as a third party independent from both issuers and investors might be in danger. For these reasons, JCR thinks that it should not perform rating in principle. In cases where a rating by other rating agency is used for a trigger, it is considered that evaluation on a probability of setting trigger in motion can become difficult.

(2) Tier 2 Instruments Eligible under Basel III Issued by Japanese Financial Institutions

As for B3T2 instruments issued by Japanese financial institutions (including deposit-taking financial institutions, bank holding companies, insurance companies, insurance holding companies, securities companies, and designated parent companies), there will be cases where terms with respect to a trigger might be short on specifics. As far as Japanese financial institutions are concerned, however, an outline can be foreseen by resolution regime including the Deposit Insurance Act that has been established for them as well as through treatments by the relevant authority at the time of approval of failures in the past. In addition, JCR thinks that extreme uncertainty or difficulty in foreseeing the future that can make a rating determination difficult could be removed, taking into consideration tendency of the Japanese authorities concerned which place emphasis on continuity of the administration. However, as the instruments are developing instruments, there is a possibility that a large variety of provisions and words might be incorporated into the triggers. JCR will examine whether or not any of these instruments can conflict with the criteria described in (1) above and then determine whether or not to initiate a rating on each instrument.

3. Notching

(1) Rating Methodology

The following is JCR's rating methodology for B3T2 instruments issued by Japanese financial institutions. As contingent capital instruments including B3T2 instruments are one of the hybrid instruments, this methodology is based on and an expansion of JCR's general methodology for hybrid securities as published in "Ratings on Hybrid Securities."

As with hybrid securities, contingent capital instruments including B3T2 instruments may be designed so that even if investors suffer loss by write-off/conversion under trigger provisions including PON clause, that would not constitute a legal default owing to the write-off/conversion itself. JCR assigns "D" rating in the event of write-off/conversion, however, so that the rating indicates the distance to such situation, as some investors emphasize principal redemption at maturity. This treatment is equivalent to that for deferred payment of interest and dividends of hybrid securities.

For hybrid securities, JCR focuses attention on the points: (1) Their claim order in the event of the issuer's failure is subordinated compared with ordinary debts and the recoverability is low; and (2) Distance to the loss due to deferred payment of interest and dividends based on the deferral clause is shorter than that to the point when debts fall into a legal default. JCR reflects these risks by notching from long-term issuer rating (lower ratings on these securities than ratings on the long-term issuer ratings). Similarly, JCR assigns ratings on contingent capital instruments including B3T2 instruments with a focus on recoverability and distance to loss, or write-off/conversion.

This methodology will be applied to instruments issued by foreign financial institutions with some adjustments. However, JCR will make a careful decision, including whether or not to initiate a rating on an instrument, with important decision factors such as relevant local regulations and financial administration.

(2) Recoverability

As with hybrid securities, it is necessary to take consideration into a risk that recoverability (degree of loss) of contingent capital instruments including B3T2 instruments could be different from that of ordinary debts in the event of principal not redeemed at maturity. In the event that these instruments are converted into ordinary shares with a trigger, order of distribution of residual property is the same as ordinary shares. In the event of write-off/conversion, contingent capital instruments including B3T2 instruments will be written off ahead of ordinary shares. Thus, it is possible no residual property is distributed to contingent capital instruments while investors for other capital instruments including subordinated bonds or loans without PON clause ("B2T2 instruments") are distributed some.

Subordinated clause is attached to B3T2 instruments as with B2T2 instruments. JCR therefore reflects this risk arising from the subordination in recovery in notching for B3T2 instruments. JCR will not in principle make notching for B3T2 instruments issued by Japanese financial institutions larger than that for instruments such as B2T2 instruments without PON clause issued by them with respect to recoverability. This treatment reflects JCR's view that PON clause is likely to be triggered in cases where the issuer is insolvent.

In light of the revised Deposit Insurance Act and the revised Ordinance for Enforcement of the Deposit Insurance Act that became effective on March 6, 2014, PON clause will be triggered in cases "Measures under Item (ii)" and "Measures under Item (iii)" provided for by Article 102, and "Specified Measures under Item (ii)" provided for by Article 126-2 of the Deposit Insurance Act are taken. These measures are basically taken in cases where the issuer is insolvent. In cases where the issuer is in insolvent, recovery rate of B3T2 instruments will become basically zero, and recovery rate of the B2T2 instruments will become also extremely low. JCR assumes that the difference in recovery rates between B3T2 instruments and the B2T2 instruments in such cases will be small.

The "Measures under Item (ii)" and the "Specified Measures under Item (ii)" can be taken in cases where the issuer falls into a state of suspension of payments (including being in danger of falling into a state of suspension of payments for the "Specified Measures under Item (ii)"), but the issuer is avoiding falling into insolvency. In cases where PON clause is triggered when the issuer has a positive net worth, recovery rate of B3T2 instruments will become basically zero. On the other hand, there is a possibility that dividend payment through bankruptcy proceedings may become larger in such cases than in insolvency cases for the B2T2 instruments. JCR thinks, however, that a possibility that the "Measures under Item (ii)" or "Specified Measures under Item (ii)" can be taken for an entity issuing B3T2 instruments, to which uniform international standard is applied with respect to capital adequacy ratio, is extremely limited, when the entity has a positive net worth. The revision of the Deposit Insurance Act has created "Specified Measures under Item (i)" together with the "Specified Measures under Item (ii)" in Article 126-2. While the "Specified Measures under Item (i)" shall not be taken for a financial institution, if the financial institution is in insolvent, these measures can be taken in cases where the financial institution is in a state of suspension of payments or may fall into a state of suspension of payments. JCR thinks at the moment it is highly likely that the "Specified Measures under Item (i)" with less likelihood of invocation of PON clause rather than the "Measures under Item (ii)" or "Specified Measures under item (ii)" will be taken in cases of a positive net worth in light of measures against financial crisis that have been taken by the relevant authority to date.

For the "Measures under Item (iii)" that shall be taken in cases where a financial institution is in insolvent and in a state of suspension of payments, if these measures are taken, recovery rate of B3T2 instruments will become zero basically. On the other hand, there is a possibility that the B2T2 instruments will continue to pay interests and repay principal. As the "Measures under Item (iii)" are measures in effect to protect a wide range of debts including the B2T2 instruments under circumstances where a financial institution is even in insolvent, JCR thinks it is necessary to take a view that chances where such measures can be taken will be scarce. It is also necessary to keep in mind particularly that the "Measures under Item (iii)" shall not apply to bank holding companies, insurance companies, insurance holding companies, securities companies, and designated parent companies unlike deposit-taking financial institutions.

In cases where degree of subordination is mitigated by measures that cause order of distribution of residual property for contingent capital instruments including B3T2 instruments to be the same as subordinated bonds without PON clause, there will be less needs to take into consideration the risk with respect to recoverability described above.

(3) Views on Distance to Write-off/Conversion

It is possible write-off/conversion is implemented before the issuer being legally default, and distance to loss generation could be shorter than that of ordinary debts for contingent capital instruments including B3T2 instruments. As write-off/conversion is equal to the principal deferral in terms of the economic impact, JCR thinks it is necessary to consider degree of risk with respect to distance to write-off/conversion for these instruments, as with the hybrid securities in general.

However, JCR does not reflect risk with respect to distance to write-off/conversion for B3T2 instruments issued by Japanese financial institutions basically. This is because JCR assumes that write-off/conversion may be implemented when the issuer is insolvent, or falls into a state of suspension of payments or is in danger of falling into a state of suspension as described above and that distance to such insolvency or suspension of payments is usually reflected in JCR's long-term issuer ratings. As for low long-term issuer ratings, there are cases where possible government bail-out has been taken into consideration strongly in the evaluation. In such cases, JCR makes evaluations of such B3T2 instruments deducting effect of possible bail-out from rating evaluation for them, resulting in a notching.

Distance to write-off/conversion could be a reason for a notching when there is a risk that a trigger may be set in motion before the issuer becomes insolvent or falls into a state of suspension of payments as de facto failure, or carries risk of falling into a state of suspension; that is, (i) when contract provisions or relevant laws and regulations about triggers include a risk of a trigger of write-off/conversion to be set in motion before the issuer becomes insolvent or falls into a state of suspension of payments, or carries risk of falling into a state of suspension, (ii) when attitudes of the relevant authority imply that a trigger may be set in motion not only for resolution but also as preventive purposes.

(4) Notching Guidelines

Based on the views explained above, JCR rates B3T2 instruments one notch below the long-term issuer rating for Japanese financial institutions in principle. Guidelines for notching (notch down) for the Tier 2 instruments will be the ones shown in the following Table.

Table: Guidelines for Notch Down for Tier 2 Instruments Issued by Japanese financial institutions

| Type of Instruments | Primary Covenants | Notch Down from Long-term Issuer Rating |
|---|---|---|
| B3T2 Instruments | Subordinated Clause, PON Clause | 1 |
| B2T2 Dated Subordinated Bonds | Subordinated Clause | 1 |
| B2T2 Undated Subordinated Bonds | Subordinated Clause, Interest/Dividend Deferral Clause | 2 |

Notes:

1. In cases where possible government bail-out has been taken into consideration strongly for long-term issuer rating, notching will be wider than that shown in the Table for B3T2 instruments because such possible bail-out is deducted from rating evaluation for B3T2 instruments.
2. In cases where it is deemed that PON clause may be invoked in a stage prior to a stage where the issuer is in a state of de facto failure, notching will be wider than that shown in the Table for B3T2 instruments.
3. In cases where it is deemed that risk of deferred payment of interest and dividends is high for B2T2 undated subordinated bonds, notching will be wider than that shown in the Table for B2T2 undated subordinated bonds.

4. Evaluation on Equity Content

As contingent capital instruments including B3T2 instruments are one of the hybrid instruments, JCR evaluates their equity content based on "Evaluations on Equity Content of Hybrid Securities" published by it. However, for Japanese banks, JCR evaluates equity content of instruments that cannot be calculated into Tier 1 capital for a regulatory purpose at zero in principle when calculating core capital, on which JCR places emphasis in determination of ratings for banks. Therefore, JCR does not count B3T2 instruments as core capital. JCR has already applied this policy to the perpetual or undated subordinated bonds issued by banks.

Although JCR evaluates equity content of hybrid instruments primarily from an economic point of view for the product design, JCR thinks that it is very important to add examinations of impact on market confidence to the evaluations for banks. Creditworthiness of banks is supported by market confidence to a large extent. Since it seems that there are many cases where the market participants use Tier 1 capital or Common Equity Tier 1 capital as measurement for confidence in banks, JCR thinks that it should be prudent in dealing with Tier 2 capital as core capital in determination of ratings.

In cases of B3T2 instruments, it is expected that instruments with about 10-year maturity period whose interest payments cannot be deferred are the mainstreams of such instruments with respect to the product design. In cases where maturity period is short like this case and interest payments cannot be deferred, JCR has a policy to set equity content of such instruments at zero.

Kenji Sumitani, Tomohiro Miyao

**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