13-D-0942
February 17, 2014

JCR Considers Modifying Rating Methodology for Tier 2 Instruments Eligible under Basel III

Japan Credit Rating Agency, Ltd. ("JCR") is considering modifying its rating methodology and describes the outline and background for these modifications below.

1. Outline

JCR is considering modifying a part of content of "Rating and Evaluation on Equity Content of Tier II Contingent Capital Instruments Eligible under Basel III" ("current methodology") with respect to its rating methodology for Tier 2 instruments eligible under Basel III ("B3T2 instruments") published on November 17, 2011. The major reasons for the modifications are progresses in circumstances made for about 2 years after publication of the current methodology, that is, developments made for position of B3T2 instruments and clarifications of handling of these instruments under resolution regime for Japanese financial institutions (including deposit-taking financial institutions, bank holding companies, insurance companies, insurance holding companies, securities companies, and designated parent companies) through (i) revision of notification in relation to capital adequacy ratio regulation under Basel III, (ii) revision of the Deposit Insurance Act, (iii) publication of proposal for revision of governmental and ministerial ordinance with respect to the Deposit Insurance Act, etc.

B3T2 instruments are instruments that are written off or converted into stock ("write-off/conversion") when the relevant authority decides that the issuer is in a state of de facto failure. For hybrid instruments including B3T2 instruments, JCR focuses its attention on difference in recoverability and difference in distance to loss occurrence between these instruments and ordinary debts and has been reflecting these differences in notching from long-term issuer rating. JCR is considering making its notching for B3T2 instruments narrower than before. If this change is made, rating for a B3T2 instrument will be one notch below the issuer's long-term issuer rating generally.

2. Basic Views

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 debt's write-off/conversion when the issuer reaches at the point of non-viability or PON. Focusing on a view that recovery rate of B3T2 instruments is very close to or even lower than recovery rate of common stock in some cases when PON clause is triggered, and therefore there can be a difference in recovery rate between B3T2 instruments and subordinated bonds or loans without PON clause ("B2T2 instruments"), JCR has set notching for B3T2 instruments wider than that for the B2T2 instruments.

JCR did not change its view that there is a difference in risks with respect to recoverability between B3T2 instruments and the B2T2 instruments. In light of content of revision of the Deposit Insurance Act promulgated in June 2013 and proposal of revision of Ordinance for Enforcement of the Deposit Insurance Act published in December 2013 primarily, however, JCR thinks that it may be less necessary to reflect this difference in ratings as additional notching that is practiced under the current methodology.

This decision 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 proposal of revision of Ordinance for Enforcement of the Deposit Insurance Act, 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 risk 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.

3. Notch Down Guidelines

In cases where the modifications under consideration are implemented, guidelines for notch down for the Tier 2 instruments issued by financial institutions 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.

4. Future Plans

JCR aims to complete the considerations of the modifications within a month from now on in light of conditions of related laws and other including enforcement of revision of the Deposit Insurance Act. JCR will not change its ratings on the first series and second series subordinated callable bonds (with subordinated clause and conditional debt relief clause) issued by Nomura Holdings, Inc., which are B3T2 instruments, for a reason owing only to the above modifications, even after the modifications have been made.

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