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Notching of AT1 Bonds by Japanese Banks and Others—No Reviews Considered at this Time

The following is Japan Credit Rating Agency, Ltd. (JCR)'s opinion on the rating of unsecured perpetual subordinated bonds with write-down clause issued by Japanese banks, etc., so-called Basel III eligible Additional Tier 1 bonds (AT1 bonds).

(1) On March 19, the Swiss Federal Financial Market Supervisory Authority (FINMA) announced its approval of the acquisition of Credit Suisse Group by UBS Group and that the principal amount of AT1 bonds issued by Credit Suisse will be reduced in full. In the acquisition, the principal reduction was triggered by the Swiss government's special support measures to enable liquidity. Although the said support was included in the clauses of the AT1 bonds, the loss occurred at a stage that many investors did not anticipate.

(2) For AT1 bonds issued by Japanese banks and other holding companies in Japan, in addition to the commencement of bankruptcy proceedings, the following two conditions are included as conditions of exemption from the obligation to pay principal and interest. (i) if the consolidated common equity tier 1 ratio (CET1 ratio) falls below 5.125%, and (ii) if it is found necessary to take the Specified Measures under Item (ii) of the Deposit Insurance Act (bail-in clause). The Specified Measures under Item (ii) are a framework for providing public financial assistance to financial institutions that have liabilities exceeding assets or are in state of suspension of payments (including cases where there is a risk of such a situation). Apart from these exemptions from payment obligations, a clause that allows the issuer to suspend interest payments at its discretion is also included.

(3) In the Credit Suisse case, the principal amounts of the AT1 bonds were fully reduced when the value of the common stock was not yet zero, and the possibility of future recovery was not expected. It can be said that the generally assumed hierarchy of loss absorption was not followed. However, JCR sees that such a situation is unlikely to occur for AT1 bonds issued by Japanese banks. In the event of legal bankruptcy of the issuer, AT1 bonds are ranked higher than common stocks in the order of recovery. In addition, if the issuer survives and the principal amount of the AT1 Bonds is damaged, i.e., in the case of (2) (i), payment obligation is not discharged in full for the principal, but only the amount required for the CET1 ratio to exceed 5.125%, and a covenant that the principal amount is recovered if the CET1 ratio is deemed to remain at a sufficiently high level is attached.

(4) JCR's bond rating for AT1 bonds issued by Japanese banks and others is basically three notches below the long-term issuer rating. This is in consideration of the risk of suspension of principal and interest payments before the issuer's legal bankruptcy and the risk of subordination in the order of recovery to general debt in the event of legal bankruptcy. As for the former, suspension of principal and interest payments, there are several clauses that could trigger the suspension of payments, as described in (2) above, and the notch difference reflects the one that is considered to be closest to the violation of such clauses. For AT1 bonds of Japanese banks, etc., to which JCR currently assigns ratings, the distance to the suspension of interest payments at the discretion of the issuer is considered to be the closest, taking into account the possibility of restrictions on external outflows under capital buffer regulations and other factors.

(5) If, as is the case with Credit Suisse this time, the suspension of principal and interest payments on AT1 bonds could occur at a timing difficult to foresee due to the discretion of the authorities, it is necessary to consider the risk. For example, in the EU, a precautionary injection of public capital into a bank that is not in a state of substantial failure may trigger a principal reduction. If this is the case, JCR will consider an additional notch down. In Japan, there is a possibility that precautionary public support may be provided through the Specified Measures under Item (i), but this is not reflected in the notch difference because it does not directly trigger a loss of AT1 bonds.

(6) The recognition of the Specified Measures under Item (ii), which is a bail-in clause attached to AT1 bonds of Japanese banks, etc., is subject to conditions such as liabilities exceeding assets, suspension of payments, or the threat of such state. Although there is room for the authorities to exercise discretion, JCR believes that these conditions are factors that increase the predictability of the bail-in. Public support without bail-in is possible under the Specified Measures under Item (i)

before a financial institution becomes insolvent. Also, the suspension of interest payments at the discretion of the issuer may also reflect the authority's intention, but this may occur only when there is a shortage of capital buffer. The Credit Suisse case does not affect these views. There is no change in JCR's assumption that the most proximate of the provisions for suspension of principal and interest payments in AT1 bonds of Japanese banks and others is the suspension of interest payments at the discretion of the issuer, and JCR believes that this risk is reflected in the current notching.

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