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JCR Considers Clarification of the Rating Methodology for Basel III Eligible Additional Tier 1 Capital Instruments Issued by Financial Institutions, etc.

Japan Credit Rating Agency, Ltd. (JCR) is contemplating clarification of its rating methodology for Basel III Eligible Additional Tier 1 Capital Instruments issued by the financial institutions, etc. ("Additional Tier 1 capital instruments") in response to expected investor needs. Its outline is described as follows.

1. Outline

With respect to capital instruments issued by the financial institutions, etc. JCR in principle takes the same rating approach as to hybrid securities in general. Namely, it evaluates the probable collectability of a given loss ("loss severity") together with the likelihood of loss infliction ("loss probability") and has the evaluation reflected in the rating by notching it down from the issuer's Long-term Issuer Rating. When JCR finds mere notching approach inadequate to register whole perceived risk of loss in the collection of principal and interest payable for given ratable instruments, it assigns a rating in accordance with the very definition of rating symbols, considering loss probability. It is possible the notching differential thereby becomes far wider apart between the rating of given Additional Tier 1 capital instruments and their Issuer Rating.

The rating process starts with notching down, by one notch as a rule, to register the loss severity. For next notching to register the loss probability, JCR identifies the one out of all relevant contractual and statutory provisions of given Additional Tier 1 capital instruments, evaluates the possibility in which the provision to be actuated, and determine the instrument's necessary number of notches to be deducted accordingly. In assessment of the possibility of such infliction, JCR firstly examines all provisions in the order of remoteness of their stipulated trigger levels and determines the possibility of each provision to be triggered. Secondly, in case of a certain provision being considered most likely to be actuated first, i.e. its trigger level being the highest, JCR evaluates the likelihood of the trigger infliction then ended up with the provision being turned on and a loss incurred, the result of which is reflected duly on the notching. The following table is the standard notching schedules being considered on the grounds of assessment of relevant contractual and statutory provisions and given loss probabilities.

Table: Examples of Contractual or Statutory Provisions for Capital Instruments Issued by Financial Institutions and Their Assessment

Assessment of the Provision (For the issuers with no material problem, financial or in other ways)	**Examples of the Provisions**	**Standard notches deductible by the loss probability**
Trigger level is very low.	**-Optional suspension of dividend/coupon payments** (Trigger: Minimum regulatory capital requirement ratio of 1/2 being unfulfilled) **-Mandatory Suspension of principal or dividend/coupon payments** (Trigger: Regulatory capital adequacy ratio of 120% required for securities brokers being unfulfilled.) **-Mandatory write-down/conversion** (Trigger: Point of non-viability (PON))	**0**
Trigger level is high.	**-Optional suspension of dividend/coupon**	**1**

	payments (Trigger: Distributable amount being inadequate.) **- Mandatory Suspension of principal or dividend/coupon payments** (Trigger: Distributable amount being inadequate.) **-Mandatory write-down, etc.** (Trigger: Common Equity Tier 1 (CET 1) ratio of 5.125% being unfulfilled.)	
Trigger level is high.		
Issuer discretion is very high.	**-Optional suspension of dividend/coupon payments** (Trigger: The issuer's discretion) (providing little constraint over the discretion)	**1**
Issuer discretion is available but likely restrained by institutional reasons or by regulatory intervention	**-Optional suspension of dividend/coupon payments** (Trigger: The issuer's discretion) (providing the issuer is subject to regulatory capital buffer requirements)	**2**
No issuer discretion and/or it is limited and involuntary	**-Mandatory write-down, etc.** (Trigger: Ordinary shares Tier 1 ratio of 7.0% being unfulfilled.)	**3**

Among various contractual provisions that the Additional Tier 1 capital instruments are equipped with, so-called low-trigger, mandatory write-down/conversion provision, etc. is likely to be considered, in most of the cases, as remote in terms of likelihood of the provision being actuated. This is because CET 1 ratio of 5.125% is considered to be a level that is hard to be negligible, either from issuer's or regulator's point of view, if it comes to the major financial institutions as large as being subject to regulatory CET 1 requirements.

Provisions such as the one for optional suspension of dividend/coupon payments subject to issuer's discretion are likely to be considered, in most of the cases, to be least remote in terms of likelihood of the provision being turned on. Theoretically they can be actuated at any time by choice and hence cannot be called remote in chances of their trigger inflicted. In practice, however, those provisions tend not to be turned on when there is little constraint against issuers' discretion. Hence JCR assigns no more than 1 to the notching due to loss probability. On the other hand, it is not unrealistic to expect that the discretion at financial institutions, etc. might be restrained for variety of institutional reasons or by regulator's wishes. In particular, in case of a given financial institution being subject to the regulatory capital buffer requirements, in which it is supposed to maintain a certain level of capital buffer or it is constrained in profit distribution entirely or in part ("capital distribution constraints"), its risk of inflicting optional suspension of dividend/coupon payments is considered to be higher than otherwise, i.e. cases without regulatory capital buffer requirements. JCR therefore assigns 2 as standard notching differential due to the loss probability in such a case.

All said, the regulatory capital buffer requirements do not necessarily make all subject financial institutions more susceptible than otherwise to the risk of inflicting optional suspension of dividend/coupon payments. Issuers would, as a rule, make all efforts to maintain adequate buffer even before such risk arises. They also are allowed to distribute profit, a part as it may be, even if buffer is in short, as long as the shortage is not too acute. It is most likely that financial institutions want to keep their preferential order of payment (payment hierarchy) among their outstanding capital instruments, where they would reduce, if forced by regulation, firstly dividend on common stock but maintain full payment of dividend/interest on Additional Tier 1 capital instruments. The case seems particularly applicable to these days when the sum of dividend/coupon payments for Additional Tier 1 capital instruments amounts to a relatively small sum. Besides, there is a possibility in which the authorities might have second thought over suspension of dividend/coupon payments if they find it counter-productive for the sake of capital augmentation at financial institutions because their investors would

hardly be pleased at no payment. Needless to say, it is wrong to believe aforementioned conditions or considerations to be applicable to all cases. The regulatory capital buffer requirements have just recently introduced in the international rules of Basel III. Their legislation in Japan is expected to start from now on, probably in the form of a public announcement and in line with international rules. Under such circumstances it is rather hard to foresee possible actions and measures taken by Japanese issuers and financial supervisory authorities in response to the cases of inadequacy in capital buffer. JCR expects, as aforementioned, the issuers would make all efforts to maintain required amount of capital buffer. It means, in other words, the inadequacy in capital buffer would make possibly a tremendous stress for the given issuer. Such an issuer may undergo, for example, huge loss in earnings or zero profit as a result.

If the case applies, the rating of Additional Tier 1 capital instruments issued by financial institutions with no particular financial or other sort of weakness is expected to be lower than their issuers' Long-term Issuer Ratings by, most likely, 3 notches or more.

2. Next steps

JCR plans to finish contemplation on this matter within a week or so and then make public a report of greater detail. It expects no case among existing ratings in which review of the rating is required as a result of the contemplation.

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