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Ratings of Hybrid Securities

The Japan Credit Rating Agency, Ltd. (JCR) has prepared basic standards for rating preferred stocks and other hybrid securities.

The JCR has already rated hybrid securities such as subordinated bonds issued by banks and funds of mutual life insurance companies. The ratings of individual subordinated bonds and funds will not change with this announcement of the standards for ratings.

The JCR has also described its method of evaluating hybrid securities as capital (the effect on the creditworthiness of the issuer). Please refer to press release 06-D-415, published with this release.

1. Rating symbols and its usage

When JCR assigns ratings on hybrid securities, it employs rating symbols that are used for long-term ratings of bonds. Rating symbols show the certainty of payment of interest, dividends, and principal by the due date when they are used for rating hybrid securities, while they denote the certainty of fulfillment of debt when they are used for rating ordinary bonds. If the payment of interest or dividends is rescheduled under a deferment provision in the original agreement, that usually does not signify default on the securities. However, considering the needs of investors, who emphasize payment of interest or dividends at the due date, JCR has decided to assign D to hybrid securities if the payment is rescheduled and to show the distance to the rescheduling, using rating symbols. Even if the payment of interest or dividends is rescheduled under a deferment provision, that usually does not signify default. JCR will not therefore assign D to the long-term senior debts because of a deferment of payment. However, failure to pay the principal and interest of fixed-term subordinated bonds without a deferment provision and failure to pay interest or dividends on liabilities with a deferment provision before the occurrence of grounds for deferment would signify a default, and the long-term senior debts would in this case be rated D.

2. Rating standards of hybrid securities

In rating hybrid securities, JCR focuses on the following: (1) Claims are subordinated to claims for general debts if the issuer fails, and the recoverability is low (subordination), and (2) The possibility of interest or dividends being rescheduled under a deferment provision is usually higher than the possibility of defaulting on the liabilities (the possibility of deferment). JCR factors in those risks by assigning a lower rating to hybrid securities than the rating for long-term senior debts (a comprehensive evaluation of the debtor's ability to fulfill debt without consideration of the debt agreement, preference, and subordination among debts, and the recoverability).

The difference in notches between the rating of hybrid securities with a subordination clause and without a deferment clause, and the rating of long-term senior debts shall, in principle, be one notch or more. The difference between the rating of hybrid securities with a subordination clause and a deferment clause and the rating of long-term senior debts shall, in principle, be two notches or more. If the rating of long-term senior debts is BBB or higher, and if the possibility of applying the grounds for deferment is considered low, the difference between the rating of hybrid securities with a subordination clause and without a deferment clause, and the rating of long-term senior debts shall usually be one notch, and the difference between the rating of hybrid securities with a subordination clause and a deferment clause and the rating of long-term senior debts shall usually be two notches.

If grounds for deferment are prescribed so that they are relatively unlikely to be applied, or if deferment or the application of grounds for deferment is expected to cause major disruptions to the issuer’s business, and if the issuer is therefore considered to be very likely to avoid deferment or the application of grounds for deferment, the difference between the rating of hybrid securities with a subordination clause and a deferment clause and the rating of long-term senior debts may be only one notch. A typical case is a bank with sound financial strength and a strong presence in the financial system that issues short-term subordinated bonds (Tier 3 bonds) with a deferment clause specifying a capital adequacy ratio of less than 8% as grounds for deferment.

If the probability of a failure rises, if the rating of the long-term senior debts lowers, and if the difference in recoverability between hybrid securities and the long-term senior debts seems to have expanded, judging from analyses of the order of claims and the balance sheet, JCR will expand the difference in notches based on an evaluation of the subordination.

If the probability of rescheduling the payment for securities with a deferment clause rises, the difference between the rating of the securities and the rating of the long-term senior debts will be larger than the standards described above. The difference in notches may be more likely to expand if the probability of deferment under the deferment clause is higher than the probability of default, for example if grounds for deferment are fairly broad, or if the financial situation worsens and is likely to become a cause for deferment, or, on the other hand, if the probability of fulfilling general debts other than the hybrid securities is very likely because of support from the parent company.

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