News Release

Japan Credit Rating Agency, Ltd.

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Cessation of LIBOR Publication and Existing Hybrid Securities—Lack of Fallback Provisions Basically Does Not Affect Assessment of Equity Content

The following is Japan Credit Rating Agency, Ltd. (JCR)'s opinion on response to cessation of LIBOR publication for existing hybrid securities.

In response to the increasing number of inquiries from issuers and other interested parties regarding whether the cessation of the London Interbank Offered Rate (LIBOR) publication for existing hybrid securities will affect JCR's assessment of equity content of such securities, JCR has summarized the issues and expresses its views.

LIBOR will cease to be published permanently from the end of 2021, and as LIBOR has not only been used as a reference for financial products and transactions, but also has an interdependent relationship with various systems and practices, parties concerned have been considering a number of issues, including transition plans such as fallback provisions, system support, and various practical procedures. Many hybrid securities (including loan forms as well as bonds, etc.) also use LIBOR as a reference rate and are subject to such considerations.

A typical hybrid security contract allows for early redemption (call) by the issuer at the end of the initial fixed-rate period, and if not redeemed thereafter, the interest rate will be floating rate with reference to LIBOR. For existing hybrid securities with this type of contractual content, intentionally not implementing procedures such as the introduction of a fallback provision, based on the assumption that the call option is exercised as soon as the call date arrives, is considered to be an option in practice. This is because the procedures require the agreement of the creditors, are complicated and there is a limited time. However, in order to adopt such an option, it is necessary to consider in terms of various aspects such as laws, systems, and practices, and one such consideration is the impact on the equity content assessment by credit rating agencies.

If fallback provisions and other measures are not taken for existing hybrid securities, the likelihood of foregoing the call options will be lower than in the case where these measures are already taken. This is a negative factor for the equity content assessment, but JCR originally assessed equity content on the premise that call options are highly likely to be exercised. In general, investors have high expectations for call options, and issuers tend to issue hybrid securities on the assumption that call options are exercised, as not exercising call options may lead to reputational risk. In its equity content assessment, JCR places a large weight on whether the equity content can be substantially maintained after the call option is exercised. As a result, many of the hybrid securities, in which JCR approves the equity content, have mechanisms in place to ensure that the redeemability of senior debt is not affected through their replacement provisions and other measures, even if the call options are not foregone. Given these mechanisms, JCR would not lower its equity content assessment of existing hybrid securities even if fallback provisions and other measures are not taken on the assumption that call options are exercised.

Based on the above, JCR sees no need to introduce fallback provisions for existing hybrid securities due to the impact on equity content assessment. However, in cases where the issuers' creditworthiness is low, such as in the BB range or lower, probability of replacement may not be sufficient, and it may be necessary to introduce fallback provisions to prepare for the possibility that the issuers will forego the call option. If the fallback provisions and other measures are not taken for hybrid securities under such circumstances, JCR may consider lowering their equity content assessments.

Kiichi Sugiura, Kenji Sumitani, Akira Minamisawa, Takahiko Yamaguchi, and Yasuhiro Shimoda

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

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