News Release
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Rating and Evaluation on Equity Content of Tier II Contingent Capital Instruments Eligible under Basel III

JCR announces the views on rating and evaluation on equity content of Tier II contingent capital instruments eligible under Basel III as follows.

1. Tier II Contingent Capital Instruments Eligible under Basel III

Contingent capital instruments are instruments that when they cause specific triggers (certain trigger events occurred), are converted into lower ranking securities such as stock or written off (hereinafter referred to as "write-off/conversion") on a mandatory basis. Tier II contingent capital instruments eligible under Basel III are the contingent capital instruments approved as Tier II capital under Basel III, which is a new framework for capital regulations for banks.

In order to be eligible under Basel III, instruments need to meet minimum requirements to ensure loss absorbency when they become non-viable. Learning from the past experiences in the financial crises that Tier II instruments did not play a role as gone-concern capital which absorbs loss when failure takes place despite occurrence of burden on taxpayers including injection of public sector capital, these requirements are added to Basel III framework as new requirements. To be more precise, contract provisions or laws and ordinances are arranged so that the relevant authority can decide whether the instruments should be written off or be converted into common stock when a trigger event occurs as a primary requirement. The trigger event is the earlier of:

(i) A decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority; and

(ii) The decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority.

2. JCR's Policy for initiating Rating

(1) Principle

JCR does not assign a rating in principle for any instruments that are considered to have factors which make it difficult for decisions on existence of infringement of a trigger or evaluations on a probability of such infringement to be made. Specifically, JCR does not assign a rating in the following cases: (i) In case where terms and content of description for the trigger provisions are extremely unclear; (ii) In case where discretions of persons other than the issuer (including the relevant authority) are used for a trigger and it is considered extremely difficult to foresee attitudes for exercise of their discretions of such persons other than the issuer; (iii) In case where factors directly unrelated to creditworthiness of the issuer such as stock price are used for a trigger; and (iv) In case where a rating (including a rating of other than JCR) is used for a trigger.

In determination of ratings, JCR will engage in measuring distance to the occurrence of write-off or mandatory conversion which causes loss to investors of the rated instruments. Measurement of the distance will become extremely difficult when the instruments come under the cases (i) through (iii) above. As for the (iv) above, there is no problem with the points that a rating is related to creditworthiness of the issuer and that it is a very clear indicator. However, in case where a JCR's rating is used for a trigger, JCR will "forecast transitions of self-determined rating and perform rating based on it," which is self-referring and cyclical work as a result. Furthermore, should a rating agency directly trigger an event to determine the level of a rating, its status as a third party independent from both issuers and investors might be in danger. For these reasons, JCR thinks that it should not perform rating in case of (iv). In case where a rating by other rating agency is used for a trigger, it is considered that evaluation on a probability of setting trigger in motion can become difficult.

(2) Tier II Contingent Capital Instruments Eligible under Basel III Issued by Japanese Banks

As for Tier II contingent capital instruments eligible under Basel III issued by Japanese banks, it can be assumed that words almost tracing the words for trigger events described in 1. (i) and (ii) above may be incorporated into the contract provisions. There will be cases where terms such as "non-viable" or "a public sector injection of capital or equivalent support" might be short on specifics.

As far as Japanese banks are concerned, however, an outline can be foreseen because resolution regime called the Deposit Insurance Act has been established for banking institutions as well as through the treatments by the relevant authority at the time of approval of failures in the past. In addition, JCR thinks that extreme uncertainty or difficulty in foreseeing the future that can make a rating determination difficult could be removed, taking into consideration tendency of the Japanese authorities concerned which place emphasis on continuity of the administration. However, as the instruments are underdeveloped instruments, there is a possibility that a large variety of provisions and words might be incorporated into the triggers. JCR will examine whether or not any of these instruments can conflict with the criteria described in 2. (1) above and then determine whether or not to initiate a rating on each instrument.

3. Notching

(1) Rating Methodology

Following is JCR's rating methodology for Tier II contingent capital instruments eligible under Basel III issued by Japanese banks. As contingent capital instruments are one of the hybrid instruments, this methodology is based on and an expanded form of JCR's general methodology for hybrid securities as described in "Ratings on Hybrid Securities" (released on September 1, 2006, Japanese only).

As with hybrid securities, contingent capital instruments are usually designed so that even if investors suffer loss by write-off/conversion under trigger provisions, that would not constitute a legal default. JCR, even in the event of write-off/conversion, assigns "D" rating to show the distance to such a situation, as investors emphasize principal redemption at maturity. This treatment is equivalent to that for deferred payment of interest and dividends of hybrid securities.

For hybrid securities, JCR focuses attention on the points: (1) Their claim order in the event of the issuer's failure is subordinated compared with ordinary debts and the recoverability is low; and (2) The distance to the loss generation due to deferred payment of interest and dividends based on the deferral clause is shorter than that to a point when debts fall into a legal default. JCR assigns lower ratings on these instruments than senior debts to reflect these risks. Similarly, JCR assigns ratings on contingent capital instruments with a focus on the recoverability and the distance to loss generation, or write-off.

In this report, "banks" include securities firms. The methodology will be applied to instruments issued by foreign banks with some adjustments. JCR will make a careful decision, including whether or not to initiate a rating on an instrument, with important decision factors such as relevant local regulations and financial administration.

(2) Recoverability

As with hybrid securities, contingent capital instruments' recoverability (degree of loss) in the event of principal not redeemed at maturity could be very different from that of general debts. JCR will consider notching about the recoverability.

In the event that Tier II contingent capital instruments eligible under Basel III are converted into ordinary shares with a trigger, the order for the distribution of residual property is the same as ordinary shares. In the event of write-off, contingent capital instruments will be written off ahead of ordinary shares. Thus, it is possible no residual property is distributed to contingent capital instruments while ordinary shareholders are distributed some. The nature of contingent capital instruments' recoverability being equal to or in some cases inferior to that of ordinary shares needs to be reflected in a wider notching difference than that of ordinary subordinated bonds and preferred securities which are placed in a position superior to ordinary shares.

When there is an extremely low possibility of a trigger to be set in motion, JCR may place notching for the recoverability to a limited extent. This is because most of Tier II contingent capital instruments eligible under Basel III are usually subordinated bonds and they are equal to subordinated bonds in terms of the residual property distribution unless a trigger is set in motion.

In the event that the contract provisions stipulate the instruments are less subordinated by making them equal to subordinated bonds in terms of the residual property distribution, JCR may make the notching difference about their recoverability same level as ordinary subordinated bonds and preferred securities.

(3) Distance to "Write-off/Conversion"

It is possible write-off/conversion is implemented before the issuer being legally default, and the distance to loss generation could be shorter than that of ordinary debts. As write-off/conversion is equal to the principal deferral in terms of the economic impact, JCR will consider notching about the distance to write-off/conversion, same as the case of notching about deferred payment of hybrid securities' interest and dividends.

However, the distance to write-off/conversion will not be reflected in the notching difference in most cases. JCR assumes that the relevant authority usually decides on write-off/conversion (setting a trigger in motion) to coincide with determination of corporate failure or insolvency in accordance with laws and regulations stipulating banks' resolution. The distance to such corporate failure or insolvency (hereinafter "de facto failure") is usually reflected in JCR's senior debt ratings. These points will be discussed again later. As for senior debts with a low rating, possible government bail-out may have been taken into consideration. Evaluation on contingent capital instruments will be made without consideration for such possible bail-out, resulting in a notching difference.

The distance to write-off/conversion could be a reason for a notching difference when contract provisions or relevant laws and regulations about triggers include a risk of a trigger of write-off/conversion to be set in motion before de facto failure or even its prospect. The same applies to cases when attitudes of the relevant authority imply a trigger may be set in motion not only for resolution but also as preventive purposes.

(4) Notching Guideline

As the recoverability after a trigger is almost equal to or in some cases inferior to that of ordinary shares, when there is a possibility of a trigger to be set in motion, such risks are reflected in a notching difference about recoverability. As mentioned before, JCR assumes that a trigger will be set in motion to coincide with the issuer's de facto failure or its prospect, and therefore, the distance to write-off/conversion is not reflected in a notching difference in most cases. When there is a possibility of a trigger to be set motion, there usually will be a difference of 2 notches compared with senior debt ratings.

To estimate the likelihood of a trigger, JCR will focus on if there exists legal ground for setting the trigger in motion. JCR assumes it is required for the relevant authority to have legal ground in determining write-off/conversion, which affects property rights of creditors and shareholders. JCR will check if any laws and regulations authorize the government to judge a bank to be in de facto failure and determine write-off/conversion that could affect debts and capital.

For some banks, even if such legal ground exists, these laws and regulations may be rarely applied for real. One example is that while a trigger is expected to be set in motion in accordance with Deposit Insurance Act's Article 102, which is intended to cope with systemic crises, it is not very likely the Article 102 will be applied if the issuer is too small to cause a systemic crisis. Even in such a case, however, a possibility of the Article to be applied is not ruled out. JCR sees a possibility of a trigger to be set in motion and usually makes a difference of 2 notches.

JCR assumes a trigger is very unlikely to be set motion if there is not legal ground for that, and its notching about recoverability may be limited. This is because most of Tier II contingent capital instruments eligible under Basel III are usually subordinated bonds and they are equal to subordinated bonds in terms of the residual property distribution unless a trigger is set in motion.

When there is a risk that write-off/conversion will be implemented far ahead of the issuer falling into a situation of de facto failure, the notching difference will be 3 or more, as the distance to write-off/conversion will be reflected in additional difference depending on the size of such a risk.

Table

Rating Guideline for Tier II contingent capital instruments eligible under Basel III

Trigger timing	Notch down compared to senior debts
De facto failure or its prospect	2~
Ahead of prospect of de facto failure	3~
Very unlikely (in terms of legal ground, etc.)	1 or 2

(Notes)

1. Possible government bail-out taken into consideration for senior debt ratings will be taken out. That could result in a wider notching difference than that shown in the table.

2. In the event that the contract provisions stipulate the instruments are less subordinated by making them equal to subordinated bonds in terms of recoverability, JCR may make the notching difference about their recoverability same level as ordinary subordinated bonds and preferred securities.

(5) Assumption for trigger

At this time, it is not clear how and when a trigger is set in motion by Japanese authorities. If these are not clearly stated in contract provisions, JCR assumes a trigger will be set in motion in accordance with resolution regimes.

For a trigger to be set in motion, Japanese authorities need to judge that the issuer is at the point of non-viability as a going-concern without write-off or capital injection, and decide that such write-off or capital injection is necessary. Financial Services Agency and other Japanese authorities have a strong regulatory power over banks, and yet they need to have legal ground in making decision on write-off/conversion, which affect property rights of creditors and shareholders. Thus, JCR assumes that regimes to settle bank failure will stand as legal ground for judging a bank to be in de facto failure and determine write-off/conversion, which could affect debts and capital.

Deposit Insurance Act stipulates the methods to settle bank failure in Japan, stating, as ordinary methods, (1) insurance pay-out and (2) financial assistance. The Act defines a financial institution that has suspended or may suspend repayment of deposit as failed. The Act also stipulates two exceptional measures to cope with financial crises - (3) financial assistance exceeding the pay-out costs towards financial institutions that are failed or insolvent, and (4) enforced acquisition by the government of entire shares of a failed financial institution which is insolvent.

Of these, (1) and (2) are ordinary methods and write-off/conversion is not likely to be considered necessary, because banks will be treated under resolution procedures like the Civil Rehabilitation Law and Tier II instruments would play a role as gone-concern capital which absorbs loss when failure takes place. On the other hand, under (3) and (4), it is possible that, while stock absorbs loss, part of or all the Tier II instruments would be redeemed or distributed with taxpayers' money injection and would not absorb loss as gone-concern capital. Write-off/conversion would be necessary to avoid such a situation. JCR assumes a situation in which the relevant authority recognizes the need of (3) and (4) (such recognition is officially made by Prime Minister after the resolution of the Financial Crisis Management Council) is the typical case when a trigger is set in motion. In other words, a trigger would be set in motion in or almost in a situation where the absence of write-off/conversion may cause deposit repayment suspension or insolvency.

Deposit Insurance Act also stipulates (5) capital injection for financial institutions that are neither failed nor insolvent, but need to enhance capital adequacy. This measure is not included in the regime to settle bank failure. JCR may make notching difference about the distance to write-off/conversion if it judges that it is highly likely (5) will be implemented far ahead of a de facto failure and resultantly a trigger will be set in motion. Resona Bank, Ltd. is the only bank that has been covered by (5), and the measure was implemented when the bank was almost in de facto failure. JCR assumes that even when (5) is likely to lead to a trigger, the need of additional notching difference is limited at this moment. Still, this matter will be judged taking into consideration relevant financial environment and administrative stances.

Meanwhile, capital injection based on Act on Special Measures for Strengthening Financial Functions' Article 5 and emergency finance under Bank of Japan Act's Article 38, which is referred to as "Tokuyu (a special loan)," are not intended to settle failure. JCR assumes these would not cause a trigger.

Assumption on triggers may change to meet changes in regulations and stances of the relevant authority. In accordance with these changes, JCR will assign ratings based on 3. (4) above.

4. Evaluation on Equity Content

As contingent capital instruments are one of the hybrid instruments, JCR evaluates their equity content based on "Evaluations on Equity Content of Hybrid Securities" (released on September 1, 2006, Japanese only). However, for banks, JCR evaluates equity content of instruments that cannot be calculated into Tier I capital for a regulatory purpose as core capital, on which JCR places emphasis in determination of ratings for banks, at zero in principle. Therefore, JCR does not count the Tier II contingent capital instruments eligible under Basel III as core capital. JCR has already applied this policy to the perpetual subordinated bonds issued by banks.

Although JCR evaluates the equity content of hybrid instruments primarily from an economic point of view for the product design, JCR thinks it very important to add examinations of impact on market confidence to the evaluations for banks. Creditworthiness of banks is supported by market confidence to a large extent. Since it seems that there are many cases where the market participants use Tier I capital or Core Tier I capital as measurement for confidence in banks, JCR thinks that it should be prudent in dealing with Tier II capital as core capital in determination of ratings.

For the hybrid instruments which are not written off/converted or cannot be written off/converted owing to the mechanisms of the triggers when banks fail, the product design does not support creditworthiness of them well. Thus, an evaluation from this perspective can work as a negative factor in evaluations on equity content of them. In addition, in case of Tier II contingent capital instruments eligible under Basel III, it is expected that the instruments with about 10-year maturity period whose interest payments are not deferrable are the mainstreams of such instruments. In case where maturity period is short like this case and interest payments cannot be deferred, JCR has a policy to set the equity content of hybrid securities at zero.

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