12-D-0423
September 10, 2012

Ratings of Hybrid Securities

Japan Credit Rating Agency, Ltd. (JCR) publicly announced a report on basic methodology for rating on hybrid securities (hereinafter referred to as "the year 2006 publicly announced report") on September 1, 2006. Given that issues of hybrid securities are increasing, JCR has clarified the methodology centered on the deferral clause. While the content of this report prevails over the year 2006 publicly announced report, this report is not intended to change the content in the year 2006 publicly announced report and is intended to clarify the explanations. There should be no changes to the ratings owing to the clarifications.

1. Rating Symbols and Its Usage

When JCR assigns ratings on hybrid securities, it employs rating symbols that are used for long-term issue rating. Rating symbols show “certainty of payments of interest, dividends, and principal by due date” when they are used for rating hybrid securities, while they denote “certainty of fulfillment of debt obligations as initially agreed” when they are used for rating bonds normally. If a payment of interest or dividends is deferred under deferral clause in initial agreement, it usually does not signify “default” on the securities. However, considering needs of investors who place emphasis on payment of interest or dividends at due date, JCR has decided to assign “D” to hybrid securities if the payment is deferred and to show distance to the deferral, using rating symbols. Even if payment of interest or dividends is deferred under deferral clause, it usually does not signify default. JCR will not therefore assign “D” or “LD” to long-term issuer rating because of the deferral of payment itself.

However, failure to pay principal and interest of dated subordinated bonds without a deferral clause or failure to pay interest or dividends on bonds with a deferral clause before occurrence of deferral event, etc. is a default, and the long-term issuer rating would in this case be rated at “D” or “LD.”

2. Rating Methodology for Hybrid Securities

In rating hybrid securities, JCR focuses on the following: (1) Ranking of Claims is subordinated to that of claims for general debt obligations when the issuer fails, and as a result, probability of recovery is low (subordination), and (2) Probability of a payment of interest or dividends being deferred under the deferral clause is usually higher than probability of defaulting on debts (probability of deferral). JCR factors in these risks by assigning a lower rating to the hybrid securities than the long-term issuer rating (evaluation of the issuer’s overall capacity to fulfill its entire financial obligations without consideration of the debt agreement, senior and subordinated relationships among debts, and probability of recovery).

Difference in notches between the rating on hybrid securities with a subordination clause and without a deferral clause and the long-term issuer rating shall, in principle, be one notch or more. Difference in notches between the rating on hybrid securities with a subordination clause and a deferral clause and the long-term issuer rating shall, in principle, be two notches or more. If the long-term issuer rating is “BBB” or higher, if possibility of triggering deferral event (for the ones with a deferral clause) is considered low, the difference between the rating on hybrid securities with a subordination clause and without a deferral clause and the long-term issuer rating shall usually be one notch, and the difference between the rating on hybrid securities with a subordination clause and a deferral clause and the long-term issuer rating shall usually be two notches.

If deferral event is unlikely to be triggered even under a certain stressful condition, or deferral or triggering deferral event itself can cause major disruptions to the issuer’s business, and if the issuer is therefore considered to be very likely to avoid deferral or triggering deferral event, the difference between the rating on hybrid securities with a subordination clause and a deferral clause and the long-term issuer rating 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 III bonds) with a deferral clause specifying a capital adequacy ratio of less than 8% as deferral event.

As for contingent capital instruments that are designed to be converted into lower ranking securities such as stock or written off on a mandatory basis when a specific trigger is touched, JCR will assign ratings to them, focusing on probability of recovery and distance to the write-off/conversion, which can be considered deferral of principal. Please refer to “Rating and Evaluation on Equity Content of Tier II Contingent Capital Instruments Eligible under Basel III” publicly announced on November 17, 2011 for rating methodology for Tier II contingent capital instruments eligible under Basel III specifically.

Table 1: Notching between Rating on Hybrid Securities and Long-term Issuer Rating

	Principle	Cases where long-term issuer rating is in or more than BBB category and probability of deferment is low.
With subordination clause and without deferment clause	1 or more	1
With subordination clause and deferment clause	2 or more (Notes 1 & 2)	2 (Notes 1 & 2)
Without subordination clause and with deferment clause	1 or more (Note 2)	1 (Note 2)

Note 1: If deferral is unlikely to occur even under certain stressful condition, or deferral or triggering deferral event itself can cause major disruptions to the issuer’s business, and if the issuer is therefore considered to be very likely to avoid deferral or triggering deferral event, notching may be only one notch.

Note 2: In a case where while possibility of support from parent company or government is factored in for long-term issuer rating, such support is unlikely to be extended to payments on hybrid securities, notching may be larger than the principle above.

3. Cases Where Notching between Rating on Hybrid Securities and Long-term Issuer Rating Can Expand

When probability of deferral increases for hybrid securities with deferral clause, JCR will increase notching between rating on hybrid securities and long-term issuer rating. In cases where deferral event is stipulated in an extremely strict fashion, that is, in a way in which an issuer triggers the event easily, or cases where certainty of fulfillment of general debt obligations other than the obligations with respect to the hybrid securities is considered extremely high owing to support from the parent company, while an issuer is about to trigger the deferral event with its financial structure worsening, notching is likely to increase regardless of level of the long-term issuer rating.

Even if the deferral clause is relatively lenient, JCR may consider an increase in the notching when the long-term issuer rating can no longer in higher rankings. This is because JCR thinks that there is a possibility that the issuer will defer the payments at its option under a situation where the earnings and financial structures are worsening significantly even in a case where only an optional deferral clause is stipulated in addition to a case where it is increasingly likely that the issuer may trigger the mandatory deferral clause.

There have been many hybrid securities with only optional deferral clause for deferral mechanism in recent years. JCR has a policy to reflect probability of deferral in notching depending on earnings and financial conditions after examining the issuer’s stance for the optional deferral clause. In particular, it is likely that the shareholders will request increasingly deferral of payments under earnings and financial situations where the distributable amount is exhausted and recovery of the amount is unlikely. Under this situation, nothing is 3 notches or more for hybrid securities with subordination clause and (optional) deferral clause. However, it does not mean that JCR does always increase the notching to more than 3 when the distributable amount of the issuer on the unconsolidated basis is exhausted at time of rating. JCR may not increase notching when it is considered that request for deferral will not be strong, judging from property of the shareholders, when recovery of the distributable amount in the near future is likely, judging from the issuer’s business and earnings conditions or when it is likely that the issuer can ensure the distributable amount through the group companies, judging from the substantive condition of the equity on the consolidated basis. Also, JCR may not increase notching even if the distributable amount is exhausted and recovery of the amount is unlikely with its earnings and financial conditions when JCR judges that it is extremely unlikely that the issuer will defer its payments as a result of examination of the issuer’s property or stance. A case as an example where the deferral of payments as in the case of bank perpetual bonds can cause significant disruptions to the bank’s fund procurement and business continuity applies to the above case.

When probability of business failure becomes higher and the long-term issuer rating is in lower rankings and when difference between the hybrid securities and higher ranking debt obligations in terms of recovery is considered to have increased apparently judging from analyses of ranking of claims and balance sheet, JCR will increase notching from a point of view of evaluation of subordination. When the long-term issuer rating is “BB” category or lower and when difference with higher ranking debt obligations in terms of recovery is considered to have increased, notching is 3 notches or more normally for hybrid securities with a subordination clause and a deferral clause.

Table 2: Cases Where Notching between Rating on Hybrid Securities and Long-term Issuer Rating Can Expand

	Cases where probability of deferment can increase (Note)	Cases where long-term issuer rating is in or less than BB category and difference with higher ranking debts obligations in terms of probability of recovery increases.
With subordination clause and without deferment clause	-	2 or more
With subordination clause and deferment clause	3 or more	3 or more
Without subordination clause and with deferment clause	2 or more	-

Note: The following are included: Cases where its earnings and financial conditions are significantly worsening to such conditions where the distributable amount is exhausted and recovery of the amount is unlikely even with only an optional deferral clause, in addition to cases where it is increasingly likely that an issuer will trigger deferral event under the mandatory deferral clause.

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