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Rating Methodology for Basel III Eligible Additional Tier 1 Capital Instruments Issued by Financial Institutions, etc.

Japan Credit Rating Agency, Ltd. (JCR) has adopted rating methodology for the financial instruments eligible as "Additional Tier 1 Capital" in the context of capital adequacy rules for the financial institutions, etc. This is the conclusion of its contemplation as announced in its news release dated January 29, 2015 entitled "JCR Considers Clarification of the Rating Methodology for Basel III Eligible Tier 1 Capital Instruments Issued by Financial Institutions, etc." The adopted methodology is in line with the contemplation and no change on individual ratings as a result is expected. On this occasion JCR rearranges its rating methodology for all capital instruments issued by financial institutions, etc. hereunder as a methodology entitled "Rating Methodology for Capital Instruments Issued by Financial Institutions, etc. ("Methodology")". The Methodology contains a preceding rating methodology as announced in a news release on March 7, entitled "Rating and Evaluation on Equity Content of Tier 2 Instruments Eligible under Basel III" and overrides it.

1. Objects and the position of the Methodology

Ratable objects of the Methodology include subordinate bonds, subordinate loans, preferred capital securities and preferred shares issuable by the financial institutions, such as deposit-taking institutions, financial holding companies, insurance companies, insurance holding companies, securities companies and designated parent companies, which are treated as capital for the purpose of regulation or accounting. The Methodology embraces the same ideas at JCR behind its rating methodology for the hybrid securities in general as announced in "Ratings of Hybrid Securities" (News Release dated September 1, 2006) and it is positioned as its extension. Hence the latter applies to the capital instruments to which this Methodology is not applicable, although there may be some cases in which, given capital instruments having particular risk profiles and contractual provisions, etc. as depicted in the below, the Methodology can be applied even if the instruments were issued by some other type of financial institutions.

The Methodology, with necessary adjustment, is applicable to the capital instruments issued by non-resident financial institutions, etc. JCR will carefully examine given cases, however, from the very ratability thereof, since it depends a great deal on the regime of legislation and financial regulation how the Methodology works.

2. Policy of ratability judgment

(1) Principle

Capital instruments issued by financial institutions, etc. are equipped, as a rule, with particular contractual or statutory provisions (“contractual provisions, etc.”) designed to be actuated when a preset trigger is pulled and thereby the payment of principal and/or dividend/interest is impeded, thus loss incurred to the investors. When JCR finds in the contractual provisions, etc. for a given capital instrument issued by some financial institution, etc. certain factors that could obstruct JCR’s judgment if such triggers are pulled or not, and/or its assessment of likelihood for them to be pulled, JCR in principle will not take such rating assignment. Following cases, for example, are unacceptable: (a) the contractual provisions, etc. are hardly comprehensible in their wording or contents; (b) some triggers depend on some non-issuer person’s discretion, including the regulator’s, and the person’s attitude of exercising his/her discretion is hardly predictable; (c) some triggers refer to a share price or some other factor that is unrelated, not directly, to the issuer's ability to pay the debt; (d) some triggers refer to a credit rating, of JCR's or other's.

The credit rating of a given ratable entity entails assessment of its remoteness to the possible events of loss being incurred on the investors. Cases (a) – (c) in the above are expected to make the assessment highly difficult. In the case (d) assessment is less problematic in a sense the credit rating being linked to the issuer's ability of debt payment. However, if the referenced credit rating is also assigned by JCR, the rating becomes a self-fulfilling or tautological process in which JCR makes assessment of one rating on the ground of another of its own. It would make a direr problem for JCR, should it make itself responsible for any trigger in such a way that renders a decisive influence on the rating of the instrument, as it might breach its independence from both issuers and investors. On the other hand, if the referenced rating came from some other rating agency, it would be difficult for JCR to measure the likelihood of trigger being pulled.

(2) Capital instruments issued by Japanese financial institutions, etc.

It is expected that there are cases in which, say, a certain trigger is defined only imprecisely in given capital instruments issued by Japanese financial institutions, etc. JCR figures the expected uncertainty for the rating and obscurity in outlook in such a case should not be as much as prohibitive against undertaking thereof, because, firstly, Japan has a well-developed failure resolution system on the Deposit Insurance Act and other legal grounds and, secondly, JCR knows the authorities' attitudes being by and large predictable because of their records of actions against failure resolutions in history and also because they tend to love administrative consistency. JCR expects, however, possibility for some new triggers to be added from now on and with various provisions and wordings, because the instruments are new yet to be developed. JCR will judge ratability of individual case to come, carefully considering criteria (a) – (d) depicted in the above.

3. Rating and notching

As in the hybrid securities in general, the capital instruments issued by financial institutions, etc. are designed, being equipped with certain preset contractual provisions, etc., that they are not immediately regarded as legally default (non-fulfillment of liability) if those provisions are turned on, thereby principal and dividend/interest payments impeded, hence loss incurred on the investors. However, JCR will assign a "D" rating, which indicates default, even if the infliction of loss is duly caused by given contractual provisions, etc. It does so, considering some investors are particular about the certainty of debt payment. Other ratings are to be assigned with appropriate rating symbols selected according to the assessment of remoteness from there, in the same way as the treatment of delay in payment of dividend/interest for the hybrid securities in general.

Rating of hybrid securities in general takes into consideration that (i) they are subordinate to the general liabilities in the order of preferential claim treatments at the time of issuer bankruptcy and hence the lower is their collectability of a given loss (loss severity) and (ii) the likelihood of loss being inflicted (loss probability) due to, among others, their deferment clause inducing deferral of dividend/interest payment is less remote than the probability of loss by legal default. These risks are registered in their ratings by notching down (ratings lowered by notching differential) from their issuer's Long-term Issuer Rating. Capital instruments issued by financial institutions, etc. are rated likewise, looking at their loss severity and loss probability.

From the viewpoint of objectivity JCR considers it desirable to see, as a rule, the types and contents of their contractual provisions, etc. as principal measure for assessment of the rating on capital instruments issued by financial institutions, etc. and apply thereto a notching method which differentiates their ratings by notching from their issuer's Long-term Issuer Rating. Specific rules of notching are explained later. It is expected, however, that mere notching approach based on somewhat mechanical rules may turn out to be inadequate to register the whole risk in concern, depending on the issuer's or other conditions. This is because the issuer's business performance and/or financial environment may become more volatile than anticipated, by which prospect of some trigger being pulled or not should be affected. Also, in the judgment of whether or not certain loss-inducing contractual provisions, etc. would be actuated, it matters that it depends on wills and wishes of the issuer and/or the authorities which are hard to generalize and hence require examination by qualitative analysis on a case by case basis. JCR therefore measures the loss probability carefully from all angles and assigns a rating according to the very definition of rating symbols, when JCR finds such mere notching approach being inadequate to register the risk of principle/interest loss at a given capital instrument. It is possible the notching differential thereby becomes far wider apart between the rating of given capital instruments and their issuer's Long-term Issuer Rating.

4. Notching for loss severity

The rating of capital instruments issued by financial institutions, etc. requires it to be considered that their risk is different from that of general liability in terms of expected collectability of a given loss at the time when a timely payment of principal/interest fails. Since they are equipped with, among other provisions, subordinate clause which makes them less preferred in the order of preferential claim treatments at the time of legal bankruptcy, JCR assigns, as a rule, 1 notch down as notching for loss severity.

5. Notching for loss probability

(1) Rules of notching

For capital instruments issued by financial institutions, etc. it is possible to happen that payment of dividend/interest is suspended or principal is written down, before their issuer is legally default, and hence its loss probability is less remote than the general liabilities. They usually have several contractual provisions, etc. that possibly induce losses before legal default. JCR identifies the one that is deemed at the time of rating assignment as the least remote from actuation thereof, and makes the evaluation of its loss probability reflected on the notching.

In assessment of the remoteness of contractual provisions, etc. from actuation thereof, JCR firstly (i) examines all of them in terms of remoteness of their stipulated trigger levels and, secondly, (ii) in case of a certain trigger being considered most likely to be pulled first, i.e. its trigger level being the highest, JCR evaluates the likelihood of the trigger infliction then bringing the concerned provision to be turned on and having a loss incurred.

When the likelihood of trigger infliction is considered to be extremely remote, i.e. its trigger level is extremely low, notching for loss probability is 0 (zero) as the risk of losses is deemed as highly unlikely. Also when the trigger infliction is expected to happen only at the time of legal default, or at proximity thereof, JCR considers the risk is already registered in the issuer's Long-term Issuer Rating, hence 0 (zero) notching.

When it is expected the trigger infliction will happen before the issuer's legal default but chances are remote, i.e. its trigger level is low, JCR assigns as notching for loss probability 1 notch down to register the risk of loss being incurred before legal default.

When the likelihood of trigger infliction is considered to be not necessarily remote, i.e. its trigger level is high, there is notching down to register the risk of losses before legal default. JCR determines necessary notches to be deducted according to the expected likelihood of trigger infliction then bringing the concerned provisions to actuation. This is because there are many cases in which the trigger infliction does not necessarily end up with actuation of the concerned provisions and infliction of losses. In evaluation of probability in which a trigger infliction will end up with actuation of the concerned provision JCR examines, as primary cause of judgment, the degree of issuer discretion allowed in the determination of whether or not a certain trigger infliction should bring about actuation of the concerned provision. To be specific, JCR gives just 1 notch down in case when the degree of issuer discretion is deemed as quite high; 2 notches when the issuer has certain degree of discretion but it might be to some extent constrained for institutional reasons or by wishes of the authorities; 3 notches when the issuer discretion is not discernible at all or very limited or marred with involuntary factors.

(2) Assessment of the contractual provisions, etc.

A standard notching schedule, based on assessment of the foreseeable contractual provisions, etc. and the remoteness of loss probability, can be produced by applying the aforementioned notching rules to the major contractual provisions, etc. among currently available ones, as in Table 1.

Table 1: Examples of Contractual or Statutory Provisions for Capital Instruments Issued by Financial Institutions and Their Assessment

Assessment of Contractual Provisions, etc. (For the issuers with no material problem, financial or in other ways)	**Examples of Provisions**	**Standard notches deductible for loss probability**
Trigger level is very low.	**-Optional suspension of dividend/interest payments** (Trigger: Minimum regulatory capital requirement ratio of 1/2 being unfulfilled) **-Mandatory Suspension of principal or dividend/interest payments** (Trigger: Regulatory capital adequacy ratio of 120% for securities companies being unfulfilled.) **-Mandatory write-down/conversion** (Trigger: Point of non-viability (PON))	**0**
Trigger level is low.	**-Optional suspension of dividend/interest payments** (Trigger: Distributable amount being inadequate.) **-Mandatory Suspension of principal or dividend/interest payments** (Trigger: Distributable amount being inadequate.) **-Mandatory write-down, etc.** (Trigger: Common Equity Tier 1 (CET1) ratio of 5.125% being unfulfilled.)	**1**
Trigger level is high.		
Issuer discretion is very high.	**-Optional suspension of dividend/interest payments** (Trigger: The issuer's discretion) (providing little constraint over the discretion)	**1**
Issuer discretion is available but most likely restrained by institutional reasons or by regulatory intervention	**-Optional suspension of dividend/interest 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: Common Equity Tier 1 ratio of 7.0% being unfulfilled.)	**3**

Notes (i) When more than one contractual provisions, etc. are relevant, the number of notches to be deducted is determined as per the one of least remote likelihood of actuation.
(ii) The table shows assessments assuming the issuer of no particular financial weakness, which may become different if the issuer condition and/or legal framework changes.

(3) Major contractual provisions, etc. and loss probability

(a) Mandatory write-down, etc. (Trigger: PON)

JCR in principle does not apply notching down for loss probability to the contractual provisions, etc. that stipulate mandatory write-down of the principal or conversion to equity or other subordinate securities if and when the issuer is announced by the authorities as practically bankrupt, or at the point of non-viability (PON). This is because JCR considers that such a write-down, etc. should be carried out at the time of insolvency or bank suspension and that the likelihood thereof is already reflected in JCR Long-term Issuer Ratings.

It would vary country by country in which situations the authorities may announce PON depending on the countries' legal frameworks. In Japan, with given knowledge about the Deposit Insurance Act (DIA, of which revision was enacted on March 6, 2014), and the Ordinance for Enforcement of DIA, PON is expected to be announced if and when one of those resolutions stipulated in Article 102 of the DIA as Resolution No. 2 or No. 3, or Special Resolution No. 2 of Article 126 - 2. The resolutions are implemented at the time of insolvency or bank suspension or in proximity thereto.

(b) Mandatory write-down, etc. (Trigger: Common Equity Tier 1 ratio of 5.125% unfulfilled)

When the provision least remote to actuation is identified to be the one that stipulates a mandatory write-down, etc. with the trigger of Common Equity Tier 1 (CET1) ratio of 5.125% being unfulfilled (so-called low-trigger mandatory write-down, etc.), JCR assigns just 1 notch down for loss probability. This is because 5.125% as the minimum of required CET1 ratio is considered to be uncomfortably low seen from issuers or regulators, if it comes to the major financial institutions choosing common international standards of capital adequacy rule and as large as being subject to regulatory CET1 requirements. Such issuers are supposed to maintain, willingly, their CET1 ratios well above 5.125% and, when it falls a bit too much, they would replenish share capital, sell some assets, or do whatever for recovery. The authorities also would support such a positive attitude of issuers. Especially, if a framework of the government's preemptive capital injection is in place and such intervention does not constitute a trigger that leads the issuer to write-down, etc. for the principal, etc. of its outstanding financial instruments, or so-called bail-ins, the governmental support for maintenance of CET1 ratios at a given issuer would become reasonably dependable. Therefore, JCR considers the trigger level of this particular provision is low, and its likelihood of actuation is remote.

(c) Optional suspension of dividend/interest payments

It is called "optional suspension of dividend/interest payments" as the issuer can choose to turn on the concerned provision at any time for whatever reasons. Hence not remote is the likelihood of its trigger being pulled. On the other hand, the issuer tends to choose not to turn on this particular provision under usual circumstances where there is little constraint against his discretion. Therefore, JCR assigns just 1 notch down for loss probability herewith.

For financial institutions, etc., which belong to the regulated industries, however, it is possible the issuer discretion to suspend dividend/interest payments is constrained for various institutional reasons or by regulator's wishes. In particular, when a given financial institution, etc. is subject to the regulation that constrains its profit distribution if it fails to build up a required level of capital buffer ("Capital Buffer Requirement"), JCR sees greater risk here than otherwise of optional suspension of dividend/interest payments being actuated.

Take Additional Tier 1 capital instruments for example, the discretionary payment is listed among constrainable profit distributions due to Capital Buffer Requirement. Chances are thus hardly negligible in which the provision of optional suspension of dividend/interest payments may be turned on as a measure of constraining profit distribution. Especially, when the issuer faces some distressed situation the payment of dividend/interest could be stopped reflecting wishes of the authorities even if the issuer has wish to pay. Considering such a risk, JCR assigns 2 notches down for loss probability to Tier 1 instruments, etc. of the issuers such as the banks under common international standard, which are subject to Capital Buffer Requirement and hence of discernible likelihood of the issuer discretion being constrained for institutional reasons or regulator's wishes.

The risk of optional suspension of dividend/interest payments is not necessarily pushed up only by the fact of issuer being subjected to Capital Buffer Requirements. Take Additional Tier 1 capital instruments for example, the issuer knows well how the market punishes deficiency in the capital buffer and hence it makes all efforts to maintain its adequacy before so required. Also, profit distribution constraint is scheduled according to the degree of capital buffer shortage, meaning a part of profit can be paid out if the shortage is not too much. It is only when CET1 ratio drops as much as near 5% for G-SIFIs, or Global Systemically Important Financial Institutions, to be totally restricted against profit distribution. It is most likely that financial institutions want to keep their desirable order of preferential payment (payment hierarchy) among their outstanding capital instruments, where they in a certain situation might consider reduction of dividend on common stock but not dividend/interest on Tier 1 capital instruments, as long as partial profit distribution is permissible. This is particularly plausible a scenario under the circumstance in which Tier 1 instruments carry only a small amount of dividend/interest. Besides, there is a possibility in which the authorities might have second thought over suspension of dividend/interest payments because they know the investors would hardly be pleased to see no payment and therefore the suspension might shy them away and not help banks' capital augmentation.

All said, it is wrong to assume aforementioned conditions or considerations to be applicable to all cases. The regulatory Capital Buffer Requirement is just recently introduced in the international rules of Basel III. Japan is expected to start introducing it in its legislation process to be enforced probably by public announcement. It is hard to foresee possible actions and measures that Japanese issuers and the authorities may then take in preparation for, or in response to, the cases of capital buffer deficiency. JCR expects, as aforementioned, the issuers would make all efforts to maintain required amount of capital buffer. In other words, the issuers are expected to be under a significant stress at the time when its capital buffer deficiency arises. Likely stress scenarios are, for instance, huge loss in earnings or zero profit. If profit is zero, the profit distribution restriction is total, hence no dividend/interest payable for Tier 1 capital instruments. If not zero profit, it is likely that a situation of significant stress will invite the authorities' concern, resulting in suspension of dividend/interest payment.

(d) Adjustment of notching for loss probability

A notching schedule depicted so far is a standard assessment at the moment, assuming the issuer of no significant financial weakness. JCR expects it to be adjusted in implementation, depending on issuer conditions or regulatory/institutional requirements, etc.

Take an example from adjustable cases as per issuer conditions. Suppose a provision which stipulates mandatory suspension of dividend/interest payment triggered by deficiency at distributable funds, the likelihood of trigger infliction is considered as remote, if the issuer has no major financial weakness. On the other hand, if the financial condition of the issuer is not strong enough, the likelihood of trigger infliction is deemed to be high, in particular when there is imminent possibility of a financial stress that could blow it out. As in this example, JCR expects in many cases the risk of impaired principal/interest of a given ratable instrument cannot be fully registered by mere mechanical application of the notching schedule. In such a case, JCR assigns a rating chosen according to the very definition of rating symbols, where it is possible the notching differential thereby becomes far wider apart between the rating of given capital instruments and their issuer's Long-term Issuer Rating.

As to possible adjustments as per regulatory/institutional requirement, a provision which stipulates mandatory write-down, etc. triggered by PON is, in principle, not subject to notching down, but it is being subjected to consideration thereof when JCR finds good reason to believe the suspension is likely to be exercised before occurrence of practical bankruptcy by way of insolvency or bank suspension, etc. To be precise, such cases include: (a) the concerned contractual or statutory provision, etc. and triggers thereof supposedly entails an intrinsic risk of dividend/interest payment being suspended before insolvency/bank suspension or such fear arises; (b) the same risk is foreseeable not just as bankruptcy resolution but as a preemptive measure, judging by the laws and regulations or from attitudes of the regulator.

Another adjustable case is that when a given Long-term Issuer Rating is low, the rating itself could have already strongly incorporated a future distress scenario of relief measures taken by the government. JCR may assign notching differentials on such a case in order to assign a rating on a no governmental support basis.

6. Standard notching schedule for various capital instruments in Japan

By applying aforementioned rules of notching for loss severity and loss probability to the capital instruments issued by Japanese financial institutions, etc. a standard notching schedule can be produced as follows.

Table 2: Standard Notching Schedule for Capital Instruments Issued by Japanese financial institutions, etc.

Type of Instrument	Major Terms of Provisions, etc.	Standard notches deductible from Long-term Issuer Rating (assuming issuers with no financial or other kinds of weakness)
Basel II Subordinated Dated Debt	Subordination	**1**
Basel II Subordinated Perpetual Debt	Subordination, Optional suspension of dividend/interest payment (Trigger: Deficiency in distributable funds)	**2**
Basel III Tier 2 Instruments	Subordination, Mandatory suspension of dividend/interest payment (Trigger: PON)	**1**
Basel III Tier 1 Instruments (assuming banks under common international standard)	Subordination, Mandatory suspension of dividend/interest payment (Trigger: Deficiency in distributable funds) Mandatory with write-down, etc. (Trigger: Ordinary shares Tier 1 ratio of 5.125%) Optional suspension of dividend/interest payment (Trigger: Issuer's discretionary choice)	**3**

Notes (i) The table shows assessments assuming the issuer of no particular financial or other kinds of weakness, which may become different if the issuer condition and/or legal framework changes.

(ii) When a given Long-term Issuer Rating is strongly reflecting a possible relief measures taken by the government in a future distress scenario, JCR assign a notching differential on a no governmental support basis and hence possibility of a greater notching differential.

(iii) Basel III Tier2 instruments which are considered likely for write-down, etc. to be suspended before practical bankruptcy, are possibly subject to a greater notching differential.

(iv) Basel II Subordinated Perpetual Debt and Tier 1 instruments which are considered of high risk of dividend/interest payment being suspended, are possibly subject to a greater notching differential.

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