



Evaluation of Equity Credit Attributes of Hybrid Securities and Rating Perspectives

(This report is an English translation of the original report in Japanese.)

What are hybrid securities?

Financial institutions have issued a large number of hybrid securities of various types in Japan, either directly or through subsidiaries. Although there were no issues by corporates for several years after NEC became the first non-financial corporation to issue trust preferred securities domestically through a subsidiary in 2001, if preferred stock is excluded, market participants have exhibited intense interest since Aeon Co., Ltd. and Nippon Steel Corporation issued hybrid securities back-to-back in September and October, 2006, respectively.

For issuers, the key advantages from using hybrid securities to raise funds include the following.

- Ability to avoid the dilution of earnings per share or the management risks that can result from issuance of common stock.
- Possibility of restructuring the cost of capital
- Possibility of basically including interest in the expenses of the issuer (the parent company when the issuer is a Special Purpose Vehicle) if the hybrid security is in the form of debt
- Contribution to financial flexibility. A hybrid security may be evaluated to a certain extent as equity in the rating agency's financial analysis, even if the security is debt, depending on the structural features of the security

On the other hand, in return for the issuer achieving financial flexibility, the interest rate on the funds raised will be high compared with general interest-bearing liabilities because investors will demand a premium corresponding to the risk.

R&I classifies the extent to which a hybrid security's characteristics are similar to those of common stock into five classes, and assigns the equity credit attributes a value. Before describing R&I's approach to equity credit attributes, let's first compare and clarify the characteristics of common stock and those of typical interest-bearing liabilities.

Common stock possesses three major characteristics. First, there is no repayment obligation because common stock does not stipulate a maturity date. Stock can remain on a firm's balance sheet indefinitely. While a company can acquire or dispose of treasury stock, there are no obligations beyond those provided by the Company Act. A maturity date is normally stipulated for an interest-bearing liability, on the other hand, and the liability must be repaid at maturity. In some cases, the issuer's financial position at the time of repayment may create hurdles to the arrangement of refinancing.

Secondly, common stock involves no obligation to pay dividends. With stock a company can increase its dividend when earnings are strong, and reduce its dividend below the normal amount – or pay no dividend at all – when operating results are severe. In addition, under the Company Act there are provisions for protection of creditors, such as the prohibitions against acquiring treasury stock or paying dividends, when a company's distributable amount is insufficient. In the case of interest-bearing liabilities, normally a company must pay the interest on the contractual interest payment dates even if the company is experiencing financial difficulties.

The third distinctive characteristic is the fact a shareholder's claim is the most subordinated if the stock issuer files for bankruptcy (subordination). In return for having no financial liability beyond the amount they have invested even if the company fails, shareholders do not receive distribution until after creditors and higher-ranking preferred stock shareholders have been paid. Because a company typically has negative equity when it fails, shareholders normally see the value of their stock plunge to zero. On the other hand, when there is a large amount of interest-bearing debt, the percentage that can be recovered declines relatively because the interest-bearing debt will rank *pari passu* with the claims of other creditors at the time of bankruptcy. Consequently, for creditors it is possible to relatively improve the recovery rate of claims as the amount of equity capital increases in the debt and equity balance.

Despite a difference of degree, hybrid securities will possess one or several of the three characteristics of common stock – i.e., (1) no repayment obligation, (2) no obligation to pay dividends and (3) subordination. R&I decides the equity credit attributes by judging these characteristics comprehensively.

For hybrid securities issued by banks such as dated subordinated debt, perpetual subordinated debt and trust preferred securities, the Financial Services Agency (FSA) has clearly provided the amounts (percentage) and details of the characteristics of products recognized for inclusion in equity capital for the respective securities, and the features of the securities also is nearly uniform. However, when corporates issue hybrid securities that have characteristics similar to common stock, there is no official institution similar to the FSA that authorizes the extent to which such securities can be counted in equity capital. This creates the possibility that various features will be introduced. Rating agencies, which occupy a neutral position, are therefore called upon to fulfill the role of judging equity credit attributes.

R&I's approach to equity credit attributes

R&I classifies the extent to which the features of a hybrid security are similar to those of common stock into five classes from the standpoint of the three characteristics of common stock described earlier: (1) no repayment obligation, (2) no obligation to pay dividends and (3) subordination.

■ Examples of hybrid securities and R&I's classifications and equity credit attributes standards

	Equity credit attributes standard	Example of hybrid securities
	0	Straight bonds
Class 1	10	Very-long-term subordinated bonds/preferred stocks (with call option) Interest/dividend accumulation and deferral possible
Class 2	30	Perpetual subordinated bond/preferred stocks (with call option) Interest/dividend accumulation and deferral possible
Class 3	50	Perpetual subordinated bonds/preferred stocks (non-callable). Interest/dividend accumulation and deferral possible
Class 4	70	Preferred stocks (non-callable). Dividend is non-cumulative, mandatory suspension to dividend payments
Class 5	90	Preferred Stock with mandatory conversion within three years. Interest is non-cumulative, mandatory suspension to dividend payments
	100	Common Stock

(1) Term to maturity

Among the three parameters, under the current low interest rate environment R&I places the greatest emphasis on term to maturity. This is because the large principal repayment amount makes refinancing the key concern in an evaluation of creditworthiness. If a hybrid security has no maturity date, there is no contractual obligation to redeem the security and the degree of financial freedom increases.

Nevertheless, many investors will expect the security to be redeemed at a certain time. The incentives encouraging redemption of a hybrid security work easily for issuers as well, although this does depend on the environment at the time of redemption. Because the issuers can set the structural features of the security in a flexible manner, the coupon rate normally is high compared with straight bonds. Even if an issue's initial coupon rate is low, the probability of redemption will be higher if the issue utilizes a mechanism to step up the coupon rate concurrent with the date when a call (prepayment) becomes possible after a certain period has passed. In this case, for example, even if no maturity date has been provided the substantive maturity date probably will be the date on which the call becomes possible and the coupon rate increases.

It is possible to mitigate the negative features caused by the call provision if replacement provision is set. A replacement provision is a pledge to procure the redemption funds in the event of a call by means that possess equity credit attributes that is equal to or greater than the security. Even if the hybrid security is called immediately prior to the interest or dividend step-up, the issuer's financial structure before and after the call will not be greatly altered because a comparable security with at least similar terms will be recorded on the balance sheet. Consequently, when replacement provisions are described clearly in the securities indenture, and R&I is able to confirm through meetings with the issuer or similar means management's intention to observe the provisions, R&I will consider such circumstances to resemble those with no call provision, even though the call provision is in place.

Moreover, even though there is a maturity date it is possible to evaluate the security differently from a simple very-long-term subordinated debt if replacement provisions are described

clearly in the securities indenture and R&I is able to confirm management's intention to observe the provisions. In this case, R&I can investigate classifying a security as Class 2 if the term to maturity exceeds 30 years, or as Class 3 if the term exceeds 50 years, even though the decision will depend on other conditions. The Aeon hybrid security mentioned above has 50-year maturity provision. Because the replacement provisions are described clearly in the securities indenture, and R&I was able to confirm through meetings with the issuer management's intention to observe the provision, R&I investigated the security as Class 2. In addition, because the security has a compulsorily “payment resource limitation provision” (described below) limiting the source of funds for interest or dividend payments to funds procured through the issuance of new stock or disposal of treasury stock when certain financial indicators have not been met, and the financial indicators set as the triggers are at an effective level, R&I judged the security at the time of issue to be “Class 3, equity credit attributes 50.”

(2) Deferral of interest and dividend payments

If the deferral of interest or dividend payments does not correspond to default under the indenture, payment does not become an obligation. If the delay or nonpayment of interest or dividends is possible when the issuer's financial condition is severe, just as in the case of common stock, this is advantageous from the standpoint of financial flexibility. The degree of financial freedom increases if the security is a type for which the period during which deferral is possible is open-ended and the interest or dividends during this time do not accumulate (non-cumulative). Conversely the advantages of deferral are limited if the interest or dividend payments can be deferred but will accumulate (cumulative) and if the interest will incurred on the deferred interest or dividends.

The form of deferral is broadly classified into two types: “optional deferral” and “mandatory deferral”. Under optional deferral, exercise of the right provided in the agreement to defer the interest or dividend payments depends on the intention of the issuer. While this means payment is affected by the issuer's financial policies, there is sufficient probability the issuer will continue paying interest or dividends, even when its financial position is considerably severe, when the existence of investors who expect receipt of continuous interest or dividends is taken into consideration.

By mandatory suspending interest or dividend payments when the issuer's financial position has deteriorated, a mandatory deferral provision eliminates such uncertainty concerning whether payment will be affected by the intentions of the issuer. By compulsorily suspending the payment of interest or dividends when the issuer has violated certain conditions decided at the time of issuance, issuer's intent does not come into play. The financial indicators and levels shall be set as triggers that shows the issuer's condition – whether it is in a situation that it has to suspend dividends from surplus on common stocks or to reduce them to a low level corresponding to the issuer. From the standpoint of the hybrid securities investors who expect receipt of continuous

interest or dividends, if the interest or dividend payments can be suspended compulsorily and will not accumulate, they must examine the terms prudently regardless of the level of the premium..

A payment resource limitation provision is used in combination with a cumulative deferral provision to mitigate this concern. This is a provision that limits the source of payment to the funds raised through new funding by means such as stock that will strengthen real capital, and not by means such as the reversal of cash equivalents existing currently on the balance sheet. Such provisions are referred to by names such as APM (Alternative Payment Mechanism) or ACSM (Alternative Coupon Satisfaction Mechanism).

When there is an accumulation period provision with a cumulative-type deferral, the only effect for the issuer is to move the payment timing. Although this might provide sufficient flexibility during a severe period, if the issuer will eventually pay the interest or dividend payments this can be considered to be no different than paying without deferral. With a non-cumulative provision, on the other hand, financial flexibility is excellent for the issuer, but the result is that investors will lose the income they had expected to receive.

Although not identical to a non-cumulative indenture from the issuer's point of view, in this case, even if interest is cumulative, the interest and dividends can be paid without injuring the present balance sheet if the source of funds for payment is restricted. For investors in hybrid securities, regardless of the source of funds for payment the concern is whether the interest or dividend payments will be made. For the issuer, on the other hand, the merit of deferral weakens if it can not prevent a cash-out when its financial position has deteriorated. For the two parties, whose interests conflict, to a certain extent this provision results in a compromise. Because further dilution of the stock can be expected if the issuer raises funds when its financial position is poor, however, there is a possibility this provision will lead to a share buyback in the future. Thus for the issuer a non-cumulative indenture unquestionably offers greater flexibility.

(3) Order of claims following bankruptcy

Establishing a subordination provision has the effect of relatively improving recovery of the senior creditors' claims upon bankruptcy. Subordination fundamentally influences the extent of loss when a borrower is bankrupt, and unlike the cases in (1) and (2) above does not directly contribute to financial flexibility in situations where a going concern is presumed. However, the issuance of hybrid securities that are clearly stated to be in a subordinated position, even more than funds procured using general unsecured debt, can serve to remove the uneasiness of senior creditor's concern about the extent of recovery becoming thinner. Consequently hybrid securities might make it easier to raise funds. This is because senior creditors, whose recovery of their own claims diminishes in bankruptcy when the amount of pari passu claims is greater than they assumed when they initially granted credit to a loan or bond, have a keen interest in the priority ranking of other creditors' claims when an issuer fails.

R&I believes that when classifying hybrid securities, ensuring the substantive financial

flexibility based on an agreement or other means is more significant than ascertaining whether an issue is classed as debt or equity capital from an accounting standpoint. In some cases R&I has judged an issue's parameters to strongly resemble common stock even though the issue is accounted for as debt, and in other cases has judged oppositely. For hybrid securities classified as debt, however, greater care must be exercised than with securities such as preferred stock that are classified as equity. When nonpayment of the principal and interest of a hybrid security violates the cross-default provision of another liability, the principal and interest payments become a substantive obligation. Furthermore, when numerous preconditions, representations and warranties or restrictive financial covenants are provided and a violation becomes a termination event, depending on the contents this might result in greatly accelerating the redemption period. Although referred to as subordinated debt, it only materializes in the event of default of the issuer. When an issuer redeems a hybrid security before maturity, the security at the point in time is normal debt and the redemption merely is identical to an early redemption of debt. For hybrid securities classified as debt in particular, sufficient care must be exercised not to diminish the effects that are similar to equity.

(4) Comprehensive evaluation

Up to this point we have concentrated on three main points in the judgment of equity credit attributes. When a hybrid security is actually structured, however, various provisions are combined. Broadly classified there are two types of provisions: factors that are indispensable for achieving the equity credit attributes class, and factors that are not indispensable but should be considered. The former are items that make it difficult to achieve the class if the factors are not satisfied. The latter are factors that must be judged comprehensively by studying whether other strong factors are present that can compensate relatively weak factors.

R&I evaluates the equity credit attributes of an issuer based on the equity credit attributes that R&I has evaluated by focusing on the hybrid security characteristics in this manner. Depending on the issuer, R&I believes different equity credit attributes can result, even if the hybrid securities are identical, as a result of confirming such matters as the reasons why the issuer selected hybrid securities as a means of funding, how the issuer will pay the interest or dividends if its financial position becomes severe and the issuer's thinking regarding a call and its dividend policy.

Interests of the issuer, senior creditors and hybrid securities investors

For a rating agency, the main point on which the process until issuance of the hybrid securities differs significantly from the process for normal securities is that consideration must be given not only to the interests of the issuer and investors in the securities, as is normally the case, but also to the interests of senior creditors such as investors in unsecured bonds who are related indirectly through the equity credit attributes. As the representative of the interests of investors in

the security subject to the rating, the rating agency normally evaluates matters such as the mechanism and securities indenture from the viewpoint of investor protection. In the case of hybrid securities, however, it is characteristic that the rating agency must consider the interest of senior creditors who have no relationship directly with the security because obtaining the equity credit attributes is assumed to be one of the issuer's major objectives.

In this case, the interests of the senior creditors do not necessarily correspond to the interests of the investors in the security. The reason is that from the standpoint of equity credit attributes, it is necessary to ensure the financial flexibility of the issuer, but the greater the flexibility the more the investors in the security will be forced to bear the burden, including deferral of interest or dividends. The extent of financial flexibility for the issuer is a disadvantage for the investors in the security. Therefore, although it will depend on the level of the premium, efforts must be made to create a product that will be accepted by "investors in hybrid securities" while continuing to ensure the equity credit attributes for "senior creditors."

As an example, consider a replacement provision. Even in case of a perpetual bond, the investors in hybrid securities normally expect the bonds to be redeemed at some point. If R&I can judge the bonds will absolutely be redeemed as soon as the issuer is able to exercise the call after ten years, however, from the viewpoint of maturity the perpetual bond is no different from a ten-year bond.

R&I does not readily consider products to possess strong equity credit attributes if R&I believes the call will be exercised. In this case, a replacement provision is one means of satisfying hybrid securities investors, while taking into consideration the senior creditors from the viewpoint of equity credit attributes. Because a security with at least the same characteristics will be recorded on the balance sheet even if the hybrid security in question is called immediately prior to the interest or dividends step-up, based on the replacement provision, the financial structure of the issuer before and after the call will not be substantially changed. The hybrid securities investors will be satisfied by exercise of the call, while on the other hand a financial structure nearly identical to the past will be maintained for the senior creditors.

Effect of hybrid securities issuance on the creditworthiness of the issuer

R&I uses the numerical value of the equity credit attributes for the hybrid securities of the issuer in its financial analysis. If it has judged the equity credit attributes of the hybrid securities issued by a certain issuer to be 50, as a rule R&I will treat half the issuance amount as an interest-bearing liability and treat the remainder as equity capital. When considering scenarios, depending on the mechanism R&I will sometimes successively decrease or gradually increase the equity credit attributes judged to be 50 at the time of issuance. The reason is that in its evaluation of risk for the rating, R&I looks not only at the financial statement ratios at that point in time but also studies scenarios for earnings and financial position that project three to five years in the future.

Let's look at the effect of hybrid security issuance on the creditworthiness of the issuer.

R&I will determine an Issuer Rating after quantitatively and qualitatively comprehending the business risks and financial risks affecting the issuer, then projecting the adequacy and stability of the future cash flow. Although financial risk including the substantive composition of equity and debt is one important component for deciding the Issuer Rating, R&I will study whether the financial structure is sufficient by comparison with the business risk. In considering the Issuer Rating, the impact of the financial risk will vary according to the magnitude, large or small, of the business risk. In general, the degree to which a change in financial structure will affect the Issuer Rating becomes greater if the firm has little business risk. Conversely there is likely to be little effect on the Issuer Rating for a firm with large business risk if there is no affect from a decrease in financial risk sufficient to offset the degree of business risk.

If the funds procured by issuing hybrid securities will not be invested as business funds and will be used simply to restructure the issuer's financial position, R&I will investigate the effect from the change in the debt and equity structure based on the equity credit attributes at the issuer. Because there is no change from past business risk, R&I will evaluate the extent to which financial risk has changed compared with the current business risk conditions, if there are no parameters that deserve special mention.

Some issuers utilize hybrid securities to raise capital for a new business or for M&A (merger and acquisition) in the US and Europe. As a means to procure funds for investment accompanied by collection risk, this is appropriate for raising capital from investors who will accept some degree of risk, and offers a means of raising funds that can be selected when, for example, an issuer wants to avoid capital increase from various reasons. In this case, R&I will factor the new business risk into the company's current business risk, and evaluate the risk together with financial risk. In particular, the greater the uncertainty of return on the investment, the more important the business risk analysis becomes in R&I's evaluation of the Issuer Rating.

Hybrid securities ratings

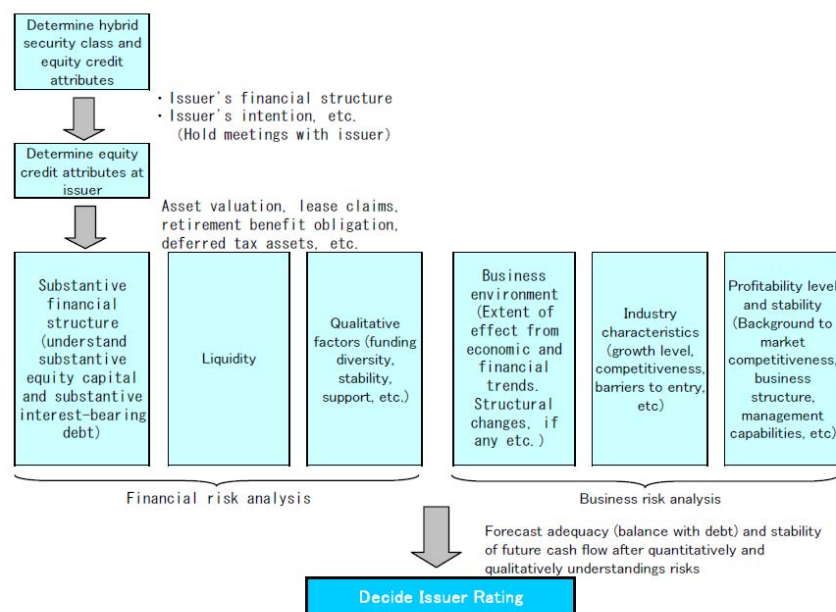
So far we have looked at the equity credit attributes of hybrid securities, and described what influence hybrid securities have on the Issuer Rating. This section describes the rating of hybrid securities themselves.

Excluding preferred stock, there are still only a handful of operating companies in Japan that have obtained ratings for hybrid securities. Many banks, however, have issued various types of hybrid securities, including dated subordinated debt, subordinated bonds and trust preferred securities.

R&I's ratings of hybrid securities for corporates exhibit a notching difference roughly similar to that for banks. For trust preferred securities with an interest or dividend deferral provision that are issued by a non-financial corporation with an Issuer Rating of BBB or higher, the hybrid securities ratings generally are two or three notches below the Issuer Rating. R&I judges whether

to assign a rating two notches or three notches lower based mainly on the level of the Issuer Rating and the probability of interest and dividends deferral. This is because the importance of the extent of the loss following a bankruptcy increases as the Issuer Rating becomes lower, and because the possibility of violating a mandatory trigger, for example, will affect the probability of deferral, depending on the level of distributable amount or the product.

Even for a security for which suspension of interest is not a default under the security indenture, R&I will downgrade the rating to CCC+ or lower when the interest has been suspended. This is because investors normally expect timely payment of interest or dividends, and the fact R&I evaluates the probability of timely payment of interest or dividends. In some cases, R&I might widen the notching difference with the Issuer Rating if it judges the probability of the interest or dividend payments being suspended has increased.



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