



R&I's Analytical Approach to Hybrid Securities and Financial Institutions

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

Substantive Determination on Priority of Claims and Possibility of Deferral

"Hybrid security" is a generic term referring to securities that have characteristics of both equity and debt. There are various types of hybrid securities, ranging from those with stronger characteristics of debt to those with stronger characteristics of equity, such as subordinated term bond, perpetual subordinated bond, preferred security, and preferred stock.

Because hybrid securities require payment of premiums on interest or dividend compared to senior debts, they have a negative impact on the cash flow of the issuer. However, for an issuer who is experiencing an imminent need to improve its financial conditions, issuance of hybrid securities may have advantages regardless of the increase in cash outflows. In particular, as financial institutions have a vital need to meet the regulatory capital adequacy ratio, hybrid securities are being widely used.

Regulatory capital consists of core capital such as equity capital (Tier I), supplementary capital such as subordinated bond and general reserves for loan losses (Tier II), and short-term subordinated bond covering market risk (Tier III), and each category includes corresponding hybrid securities. When rating these securities, the priority of claims at the time of subordination event and the possibility of deferral of interest or dividend payments will be assessed in substance, and their ratings will be notched down from the Issuer Ratings.

Subordinated Term Bonds and Perpetual Subordinated Bonds

The ratings for subordinated term bonds and perpetual subordinated bonds reflect the extent of subordination of the claims against senior claims such as deposits and straight bonds in case a subordination event such as bankruptcy, corporate rehabilitation, and civil rehabilitation occurs.

In addition to the subordination of the claims, perpetual subordinated bonds may defer interest payment if the distributable amount does not exist, which presents a risk to an investor expecting scheduled payments. Therefore, the possibility of deferral of interest payment needs to be reflected in the rating. However, whether or not to defer interest payments is at the discretion of the issuer; therefore, in addition to the availability of distributable amounts, understanding the issuer's intent will be important. In the past, even when the distributable amounts were exhausted, issuers continued interest payments for perpetual subordinated bonds. Examples include the Long-Term Credit Bank of Japan (currently, Shinsei Bank), which was briefly

nationalized, and Resona Bank which became a "special support financial institution." There is little advantage to the issuer in suspending interest payments, because the payment obligation is only deferred until the next fiscal period.

Taking these points into consideration, R&I believes it is not necessary to overly emphasize the likelihood of deferral in ratings. As such, under normal circumstances, subordinated term bonds are notched down by one notch, and perpetual subordinated bonds are notched down by two notches from the Issuer Rating. However, if R&I determines that the issuer does not have a sufficient distributable amount or the intent to continue interest payments, the rating of a perpetual subordinated bond will be downgraded significantly.

Short-Term Subordinated Bonds (Tier III Bonds)

Short-term subordinated bonds (Tier III bonds) generally have a maturity of two to five years, and respond to the risk of loss in the on-balance sheet and off-balance sheet positions caused by the volatility of the market price (market risk). In case of a subordination event, Tier III bonds have the same level of priority as the claims by subordinated term bonds, which are classified as Tier II. However, the probability of deferring principal and interest payments must be reflected in the rating, as there is a lock-in clause which prohibits principal and interest payment unless a capital adequacy ratio of 8% or higher is maintained after such payment. If the likelihood of deferral is deemed to be negligible, their rating will be the same as the subordinated term bond; but otherwise, their ratings will be lower.

Under normal circumstances, the likelihood of triggering the lock-in clause is dependent on the creditworthiness of the bank. As the financial basis becomes more vulnerable, the likelihood that the capital adequacy ratio would fall under 8% and that the bank would plunge into a situation where it cannot recover the 8% level for a considerable time increases. Supervisory authorities will not permit payment of the principal and interest in such a case. On the other hand, a high-rated bank will fear that a deferral of principal and interest would tarnish its reputation and would try to avoid such a situation, as they would have better capability to do so.

An Issuer Rating in the AA zone or higher is considered to represent a very small risk that principal and interest payments will be deferred. Under normal circumstances, an issuer in the A zone is considered to represent a small risk that its capital adequacy ratio will fall below 8%. However, even if an issuer is rated in the A zone, if there was more emphasis on public support aspect than on an assessment of the financial basis for its rating, individual evaluation on the probability of stably maintaining 8% capital adequacy ratio will be necessary. For an issuer rated in the BBB zone or lower, the risk of deferral will be reflected in the evaluation.

Taking the above into consideration, in general, Tier III bonds will be notched down from the Issuer Ratings: one notch for issuers with ratings of AA zone or higher; one to two notches for those in the A zone; and two or more notches for those in the BBB zone or lower.

Preferred Stocks and Preferred Securities

The priority of claims and the probability of dividend deferral are also assessed for the rating evaluation of preferred stocks and preferred securities. As investors expect dividend payments in accordance with their agreement, the issuer's intent and capacity to pay dividends are important. Measures taken by the supervisory authority is another critical factor.

Under the Companies Act, preferred stocks cannot make dividend payments unless distributable amounts exist. Therefore, as the likelihood of deferral becomes high, the rating will inevitably be very low (CCC+ or lower in case of suspension of dividend payment). However, as this would be in accordance with the dividend suspension clause of the security, it would not directly affect the Issuer Rating or the ratings of other securities.

Where the creditworthiness of the issuer remains sufficiently high, such risks are small, and as the creditworthiness declines, the likelihood of dividend deferral will increase. If the Issuer Rating is in the AA zone or above, it is not necessary to set a notch difference between the rating of preferred securities or preferred stocks and that of perpetual subordinated bonds. Therefore, preferred securities and preferred stocks are notched down by two notches from the Issuer Rating, the same as perpetual subordinated bonds. If the Issuer Rating is in the A to BBB zone, a case-by-case analysis is necessary to determine whether or not to factor in the likelihood of dividend deferral. Accordingly, the notch difference is two or three, allowing for some latitude. For issuers rated in the BB zone or lower, the notch difference is three or more.

The table below indicates the general relationship in the notch difference between the various types of securities and Issuer Ratings, based on the Issuer Rating zones.

■ General difference in notches between hybrid securities and Issuer Ratings

	Subordinated Term Bond	Tier III Bonds	Perpetual Subordinated Bond	Preferred Securities/Stocks	Common Stocks	
Regulatory Capital Adequacy Classification	Lower Tier II	Tier III	Upper Tier II	Tier I	Tier I	
Priority of Claim at Subordination Event	Subordinate to Senior Bonds	Subordinate to Senior Bonds	Term Bond > Perpetual Subordinated Bonds >= Preferred Stocks	Subordinate to Bonds, Preferred to Common Stocks	Most subordinated	
Maturity	5 years +	2 years +	perpetual	perpetual	perpetual	
Interest (Dividend) Deferral Clause	N/A	Cumulative	Cumulative	Non-Cumulative	Non-Cumulative	
Notch Down from Issuer Ratings	AA zone or above	1	1	2	-	
	A zone	1	1-2	2	-	
	BBB zone	1	2	2	2-3	-
	BB zone or lower	1	2 or more	2 or more	3 or more	-

(Note 1) Those in a standard pattern are assumed.

(Note 2) Notch down indicates the difference with Issuer Rating.

(Note 3) Further notching down may be possible if likelihood of suspension of interest (dividend) payment becomes higher. If payment is suspended, the rating will be CCC+ or lower.

These are only "general" notch differences. R&I may assign a rating that differs from the general notch difference, depending on the details of each security, as well as the conditions of each issuer such as the size of distributable amounts, which are the source of dividend payments. For example, if an Issuer Rating is relatively high as a result of strongly reflecting public support regardless of the issuer's poor financial conditions, the notch deferral from the Issuer Rating may

widen because the likelihood of dividend deferral depends on the financial conditions of each issuer.

Foundation Funds of Mutual Life Insurance Companies

The foundation funds of a mutual company refer to capital received from fund contributors as prescribed in the Insurance Business Law, and is recorded under net assets in the balance sheet. The fund contributors do not have the capacity to participate in management and they receive interest payments similar to those paid to loans, as well as repayment of principal on a predetermined maturity date. Therefore, economically the funds have characteristics closer to fixed interest term debt, and under normal circumstances, the fund contributors expect repayment of the fund in accordance with a set schedule.

The fund is subordinated to insurance obligations and other debt in case of settlement under bankruptcy or rehabilitation proceedings, as well as in corporate liquidation proceedings. Insurance Business Law Article 55 sets forth that the maximum limit on payment of interest for funds may not exceed the amount of net assets on the balance sheet after deducting the sum total of the total amount of funds, deficiency reserve and the reserve for redemptions and other specified amounts, and interest payments will be deferred if there is an insufficient amount to make the payment.

The rating of a fund evaluates the likelihood of payment of the principal and interest on the dates prescribed in the fund contribution agreement. Due to the attributes of the fund stated above, its rating must be notched down from the Insurance Claims Paying Ability. On the other hand, although the fund has some characteristics of capital, it has a set maturity, and it cannot be said to have strong capital attributes. In addition, other than insurance obligations, it has very little general debt. Taking these factors into consideration, R&I believes there is no need to assign significant difference between the Insurance Claims Paying Ability and the rating of a fund in case of a highly rated life insurance company. Therefore, if the Insurance Claims Paying Ability is rated in the A zone or above, the fund is rated one notch lower, at the same level as subordinated term bonds.

However, as the creditworthiness declines, the likelihood of breaching Article 55 of the Insurance Business Law and deferring interest payments becomes higher. Thus, where the Insurance Claims Paying Ability is rated BBB zone or lower, further notching down will be necessary, and depending on the level of creditworthiness, the fund's rating may become lower than the perpetual subordinated bonds. If interest payment is actually suspended, the rating will be CCC+ or lower, as is the case with preferred stocks and preferred securities.

Effects on the Issuer's Creditworthiness

With respect to the effect of the hybrid securities on the creditworthiness of the issuer, more

importance will be attached to the actual level of their contribution to the enhancement of capital than their effect on raising the regulatory capital adequacy ratio. However, regulatory capital adequacy ratio cannot be ignored, because it is important for the smooth operation of a financial institution.

When determining the level of capital attributes of a hybrid security, the following factors will be deemed important: 1) the priority of claims in the case of bankruptcy; 2) whether or not redemption of the obligation is mandatory, and 3) whether or not the payment of interests or dividends is mandatory. If payments are not substantively mandated, and there is high likelihood that the issuer can choose not to pay, such hybrid security will be deemed to have strong capital characteristics.

For example, if a maturity date is not set, redemption of debt is not a contractual obligation. However, in most cases there is a step-up clause which sets the interest rate to rise after a fixed period, as well as a call option for the issuer. Therefore, if there is high likelihood that the issuer will exercise this option, such redemption is deemed virtually mandatory.

As indicated in the table below, R&I classifies hybrid securities issued by business corporations by assigning "zero" capital attributes to straight bonds, "100" to common stocks, and creating five classes in between: Class 1 being close to straight bonds and Class 5 being close to common stocks. Each class is assigned a standard of 10, 30, 50, 70 and 90 to indicate the strength of their capital characteristics.

The classification for financial institutions is basically the same as that for business corporations. However, the classification must be adjusted taking into consideration the peculiar aspects of the financial institutions. For financial institutions, actual level of Tier I is important, because the sum of Tier II and Tier III capital cannot exceed the amount of Tier I. If Tier I capital decreases, the excess amount of Tier II and III capital must be excluded from capital for capital adequacy purposes. Since a negative net worth triggers financial institutions' bankruptcy, Tier II capital cannot be highly evaluated.

Even among Tier I capital, assessment of capital attributes will differ based on the intent of the issuer. Therefore, the capital attributes must be examined for each security, taking into consideration the product characteristics and the issuer's financial policy. For example, under normal circumstances, a preferred stock with mandatory conversion clause requiring conversion to common stocks will have stronger characteristics of capital as the mandatory conversion deadline draws closer. On the other hand, a preferred stock that essentially assumes extinguishment will have weaker characteristics of capital, as the likelihood of extinguishment will increase as the deadline gets closer. The intent of the issuer may change in the future, so the situations surrounding the issuer will also have an impact. Taking these factors into consideration, the strength of the capital attributes of hybrid securities issued by financial institutions is evaluated using the same standards as applied to other business corporations, with adjustments indicated in the below table.

The effect on the issuer is not determined only by the type or amount of the hybrid security to be issued. The effects differ based on the financial conditions and problems surrounding each issuer as well as its financial strategies, and as both positive and negative effects are possible, a careful review is required.

For example, issuance of hybrid securities that raises the capital adequacy ratio of a bank which already has sufficient capital to cover risks will not have a positive effect. On the other hand, it will be an option for a bank if the capital adequacy ratio is preventing a new business development.

As financial institutions will be subjected to a prompt corrective action if they are unable to maintain the regulatory capital adequacy ratio, they are required to rapidly reduce their assets if they cannot maintain sufficient capital. Issuance of hybrid securities would be effective to some extent for a financial institution in such situation in order to retain its operational basis.

Nevertheless, if a financial institution overly relies on hybrid securities that have less capital attributes than common stocks, such capital strategies are not sound. Following the turmoil in the global financial and capital markets since the fall of 2008, more emphasis tends to be placed on the quality of capital. When the market turmoil set in, many financial institutions raised capital by issuing preferred securities and other hybrid securities. However, in response to the worsening and prolonged turmoil, they began to shift to capital raising through common stocks.

R&I has been considering the quality of capital to be important. When assessing capital adequacy, R&I evaluates the absolute amount of substantive Tier I capital relative to risk exposures by taking capital attributes into consideration.

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

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

■Adjustment for Financial Institutions (General Rule)

- Preferred stocks with extinguishment assumptions will be deemed to be 1 rank lower in terms of capital attributes compared to the same type of preferred stocks.
- Preferred stocks with extinguishment assumption with less than 3 years until mandatory conversion will be deemed 1 rank lower in terms of capital attributes compared to those that have 3 years or longer until mandatory conversion.
- Those with discretion for deferral of interest/dividend payment will have less capital attributes compared to those with mandatory suspension clause.
- Actual level of Tier I will be considered important.

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