

Article Title: ARCHIVE | Criteria | Corporates | General: Feasibility Of Replacement Capital Covenants Under Japan's Legal Framework Data: (EDITOR'S NOTE: —This article has been superseded by "Hybrid Capital: Methodology And Assumptions," published July 1, 2019.) Hybrid capital securities often include terms whereby the issuer has the right to call the instrument at par on the same future date that the coupon rate increases or steps up, by a pre-set amount. The call and step-up are designed to prompt issuers to repurchase the issue and thus put in question the permanence of the issue. Permanence is a fundamental feature of equity, and thus the existence of a call and step-up undermines the equity content of a hybrid capital security. Legally binding replacement capital covenants (RCCs) commit the issuer to maintain or replace the hybrid instrument and thus alleviate concerns about the permanence of the hybrid capital in question. The article "Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions," published Oct. 22, 2012, clarifies that RCCs would be required for unregulated entities' future hybrid securities with calls and material step-up features in order for these instruments to qualify for the "intermediate" equity content designation. The exception to the rule would be in countries where RCCs have no legal basis or are otherwise not practicable. We have been researching the feasibility of RCCs in various jurisdictions and have concluded that the RCC is not practicable under Japan's current legal framework. This report outlines the rationale of our conclusion.

Typical RCC Typically, RCCs are structured for the benefit of a designated class of long-term senior debt-holders. While such covenants normally cannot be absolutely enforced, they explicitly grant to senior creditors a right to sue the issuer if the covenant is breached.

Hurdles Under Japan's Legal Framework Japan has a law (Civil Code, article 537) which states that in order to grant a third party any right by the effect of an "agreement made for the benefit of a third party", there must be the "expression of intent to enjoy such right" by such third party. Even if the beneficiaries are formally notified in writing, they still need to express the intent to enjoy such a right. In practice, in order for a hybrid capital issuer to grant to senior creditors a right to take legal action against the issuer in the event the issuer were to call the hybrid without replacing it with an equity-like security, senior creditors must express their intent to enjoy the new right prior to any hybrid call without replacement. We believe it would be unreasonable to expect Japanese issuers to go through the cumbersome process of confirming the agreement of senior creditors to validate the RCC legally. Although it is generally considered that expression of intent to enjoy the right may be an implied one, it would be cumbersome to obtain evidence which would adequately establish that senior creditors expressed such intent. Moreover, even where a certain senior bondholder expresses his intent to enjoy the rights provided under the RCC, any investor who purchases his bonds would not be able to exercise the RCC unless either the seller assigns to the purchaser the right under the RCC obtained by the seller's expression of intent, or the purchaser expresses the same intent himself.

Bond Trustee's Role Some may argue that if senior debt is in the form of a bond, the bond trustee can express the intent to exercise the right on behalf of the bondholders. However, in the case of a "bond" issued under Japanese Corporate Law, the bond manager ("shasai kanrisha") will act as "trustee" and the law explicitly defines bond managers' authority, which is limited to "any and all acts and things at court as well as out of court proceedings that are necessary to receive payment of claims on the bond or to ensure realization of those claims for the benefit of the bondholders" (Article 705, Paragraph 1), in addition to certain powers and authorities set forth in the bond management agreement. Although the expression of intent to enjoy the benefit under an RCC will enhance the issuer's creditworthiness, we have been advised by counsel that the expression of such intent cannot be viewed as the act to ensure realization of claims on the senior bond. If the expression of intent to enjoy the benefit under an RCC is judged to be outside of the bond manager's authority granted by law and the bond management agreement, such expression made by the bond manager, if any, will not give any right to holders of the relevant senior bonds. Also, when it's unclear whether a certain action falls under a bond manager's authority, Japanese bond managers are generally hesitant to undertake such action at their discretion.

Adding RCC To Existing Bond Indenture Since we view the typical RCC as not practicable in Japan due to the reasons cited above, we also examined the feasibility of adding an RCC to existing senior bond indentures. However, in general, amendments to the terms and conditions of bonds issued under Japanese Corporate Law require the prior approval of bondholders. We think it would be excessively cumbersome for the issuer to arrange bondholder meetings to make the RCC legally valid. Importance

Of Assessing Issuer's Intention To Replace Given our conclusion that RCCs are not feasible in the Japanese context, we do accept intent-based replacement provisions of Japanese issuers in certain cases. Historically, Japanese companies have generally demonstrated a tendency to behave in line with the expectations of the market. Also, it is not common for the top management of Japanese companies to change in an unexpected manner that would result in abrupt changes in financial policies. We take these factors into account in our assessment of the reliability of the intent-based replacement language. However, there are many different types of companies in Japan and the corporate culture within these companies has historically been evolving, and should continue to do so. Therefore, in assessing replacement provisions, it is crucial for us to assess the issuer's intention to replace on a case-by-case basis. There is no single formula to assess such intentions, and we examine various factors which include, but are not limited to: How visibly the replacement language is communicated to the market. Our intermediate equity credit designation for Japanese unregulated entities' hybrids with calls and material step-ups requires visible communication of the replacement intent with the market, typically via the issuers' annual reports, investor relations public meetings, or individual press releases; in addition to the statements of the terms and conditions of the hybrids; The issuers' financial policies; What type of carve-outs and caveats are included in the replacement language. Revisions And Updates This article was originally published on July 3, 2007. These criteria became effective on July 3, 2007. Changes introduced after original publication: Following our periodic review completed on April 15, 2016, we updated the contact information. Following our periodic review completed on May 3, 2017, we made some minor revisions to outdated wording and removed a reference to a noncriteria commentary published in 2007. Following our periodic review completed on April 26, 2018, we added the "Revisions And Updates" section. Related Criteria And Research Related Criteria Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions, Oct. 22, 2012 Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008 Related Research Unregulated Issuers' Hybrid Capital Instruments With Step-Ups--Why Be Concerned?, June 21, 2007