Investment Opportunities for Japanese Capital Securities

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PASSION FOR THE BEST

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1. Japanese Capital Securities

2. Increasing Investment Opportunities

3. Product Features of Different Capital Securities

4. Credit Valuation on Issuers

Summary

- Japanese firms (banks, insurers, non-financial firms) watching for further utilization/issuance of capital securities

- First, they will likely plan to issue yen-denominated bonds. However, issuance of USD-denominated bonds also expected in the case of (1) limited domestic demand and/or (2) overseas market being more attractive.

- Attractiveness of Japanese capital securities— stable creditworthiness at issuers

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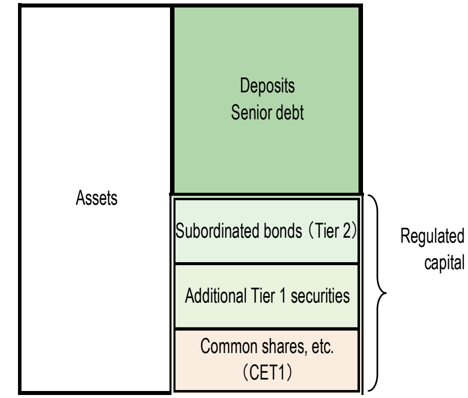
1. Capital Securities: Method to Procure Regulatory Capital and Quasi Capital

1-1. Banks: Regulations on capital adequacy ratio（Basel Ⅲ）

Banks (financial holding companies)

（Tier2 securities) Basel III-compliant Tier 2 subordinated bonds: B3
（Additional Tier1 securities） B3AT1 with debt claim

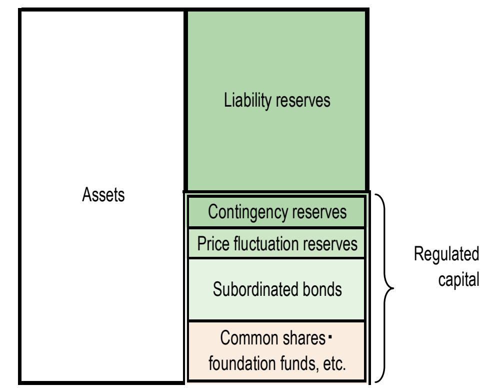
※Incl. securities firms' ultimate parent companies (Daiwa Securities Group, Nomura Holdings).



1-2. Insurers: Solvency margin regulations

Insurers

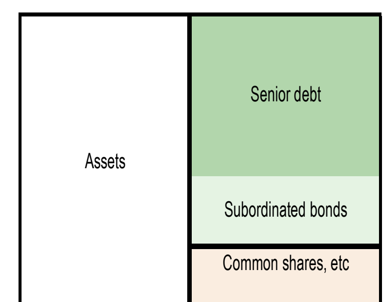
（Subordinated bonds）Term debt/superlong/perpetual
（Capital of mutual companies）Foundation fund bonds



1-3. Non-financial companies: Quasi capital, mezzanine fundraising

Non-financial firms

Subordinated bonds with equity credit (quasi capital)
Simple subordinated bonds (mezzanine fundraising)



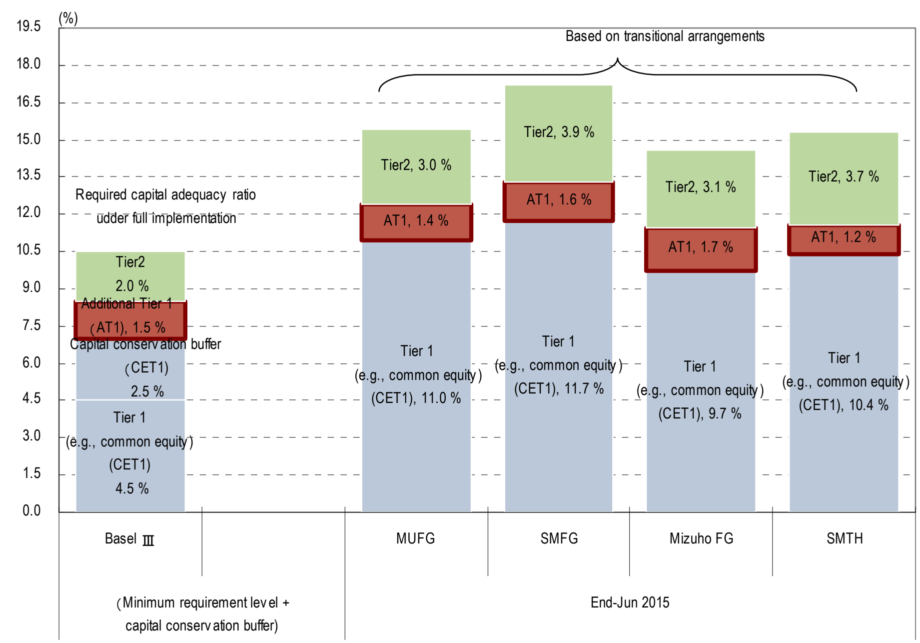
Source: Compiled by Daiwa Securities.

2-1. Banks: Transition Period from Basel II to Basel III

■ Some banks (such as Mitsubishi UFJ Financial Group [MUFG] and Sumitomo Mitsui Trust Holdings [SMTH]) started to raise returns to shareholders via share buybacks

■ Banks shifting capital policy from CET1 to AT1 & T2

Capital Adequacy Ratio at Japanese Major Financial Groups



Source: Financial Services Agency, company materials; compiled by Daiwa Securities.

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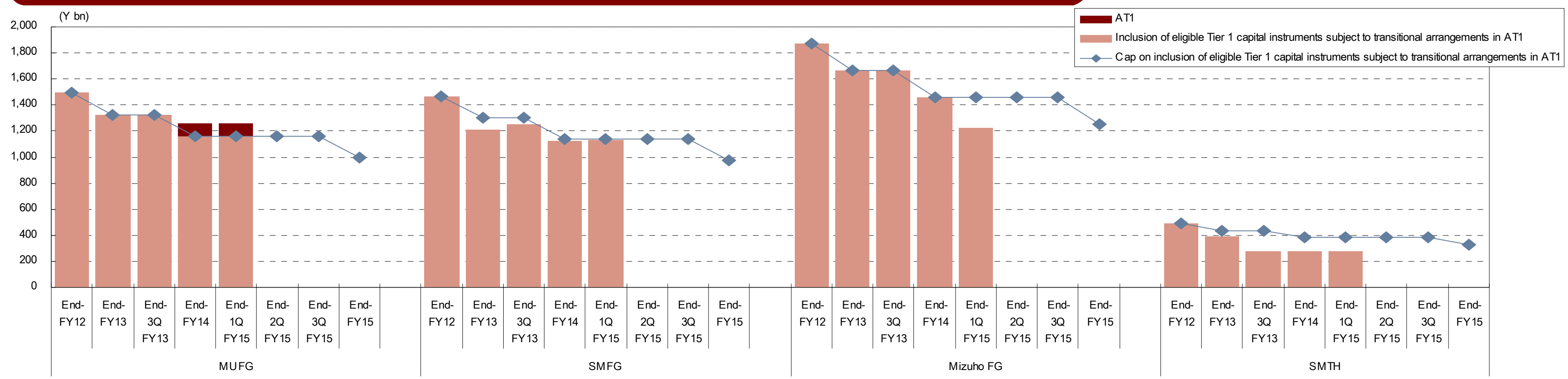
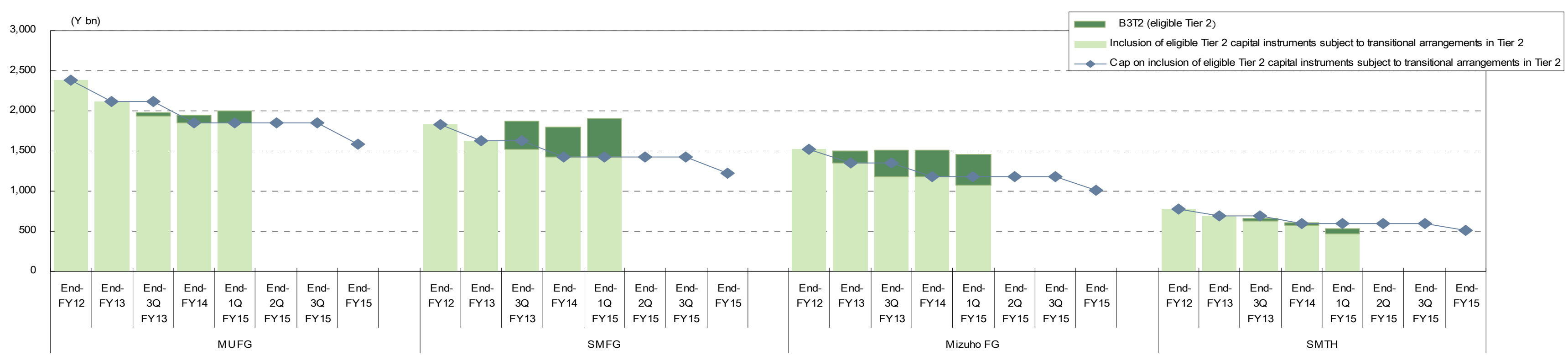
- **Eligible Tier 1/Tier 2 capital instruments subject to transitional arrangements to decline**
- **Replacement to B3AT1/B3T2 just started**
- **Market potential is significant (B3AT1：Y3～4tn, B3T2：Y4～5tn)**

Eligible Tier 1 Capital Instruments Subject to Transitional Arrangements, Issuance of AT1



Eligible Tier 2 Capital Instruments Subject to Transitional Arrangements, Issuance of B3T2

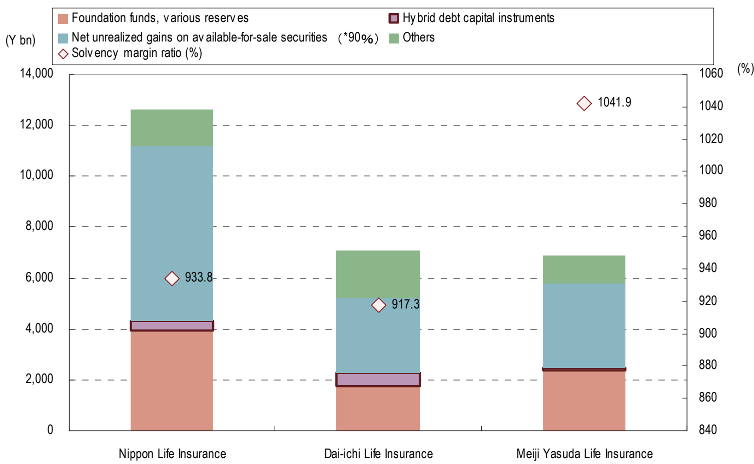


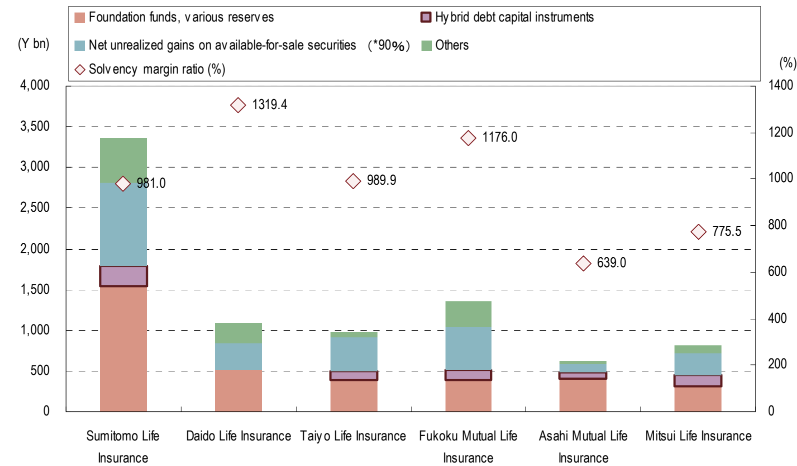
Source: Company materials; compiled by Daiwa Securities.

2-2. Insurers：Significant Scope to Utilize Capital Securities

- **Strong needs for capital reinforcement due to growth-oriented policy, indicating significant scope to utilize capital securities**
- **Replacement demand for already issued capital securities anticipated**

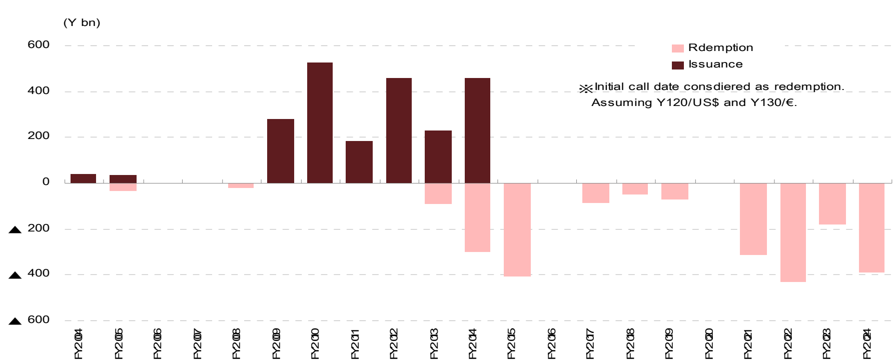
Solvency Margin Components (end-Dec 2014)





Source: Company materials; compiled by Daiwa Securities.

Procurement/redemption of Insurers' Hybrid Debt



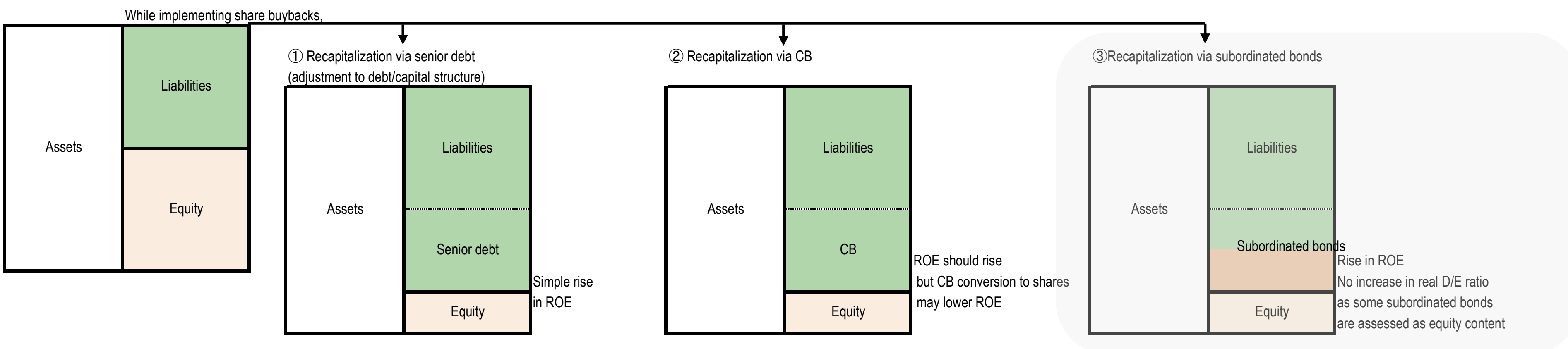
Source: Compiled by Daiwa Securities.
Note: Based on company disclosures.

2-3. Non-financial Companies：Abenomics to Boost Utilization

- Third arrow of Abenomics requires ROE improvement at companies
- Adjustment to debt/capital structure（recapitalization）is financial strategy to improve ROE
- Some firms (e.g., Softbank) started to utilize subordinated bonds to improve debt structure

Utilization to adjust debt/capital structure (ROE improvement)

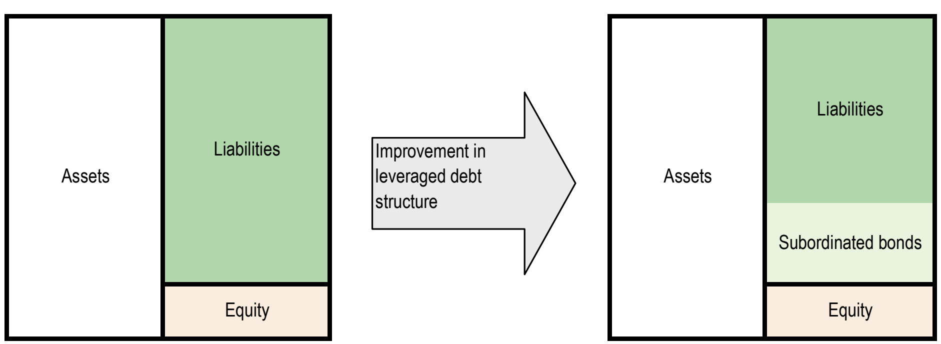
Utilization of subordinated bonds with equity content



Source: Compiled by Daiwa Securities.

Utilization to improve debt structure
(improvement in creditworthiness of senior debt)

Utilization of subordinated bonds as mezzanine fundraising



Source: Compiled by Daiwa Securities.

USD-denominated Japanese Capital Securities

1. Bank capital securities

B3AT1: Issuance of USD-denominated bonds yet to begin
B3T2: Two USD-denominated bonds issued
Many USD-denominated B2-compliant capital securities issued

2. Insurer capital securities

Some USD-denominated bonds issued

3. Non-financial companies’ capital securities

Issuance of USD-denominated bonds yet to begin

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3. Product Features of Different Capital Securities

Comparison of Characteristics of Capital Securities

	Interest rate: Absolute value	Interest rate: vs. product risk	Probability of redemption (vs. expected redemption date)	Probability of interest payment	Market liquidity	Risk weighting (※In case of investment by financial institutions)
Banks: Tier 2 capital instruments（B3T2)	△	○	◎ ※Bullet type ○ ※ With call option	◎	◎	△
Banks: Additional Tier 1 capital instruments（B3AT1)	◎	△	△	△	△	△
Insurers: Subordinated bonds	○	○	○	○	△	△
Insurers: Foundation fund bonds	△	△	○	○	○	△
Non-financial firms: Subordinated bonds	○	○	△ ※With call option ◎ ※Bullet type	△ ※With call option ◎ ※Bullet type	△	◎

Source: Compiled by Daiwa Securities.
Notes: 1) ◎, ○, △ denote attractive, reasonable, less attractive, respectively.
2) Above assessment based on my subjective opinion.

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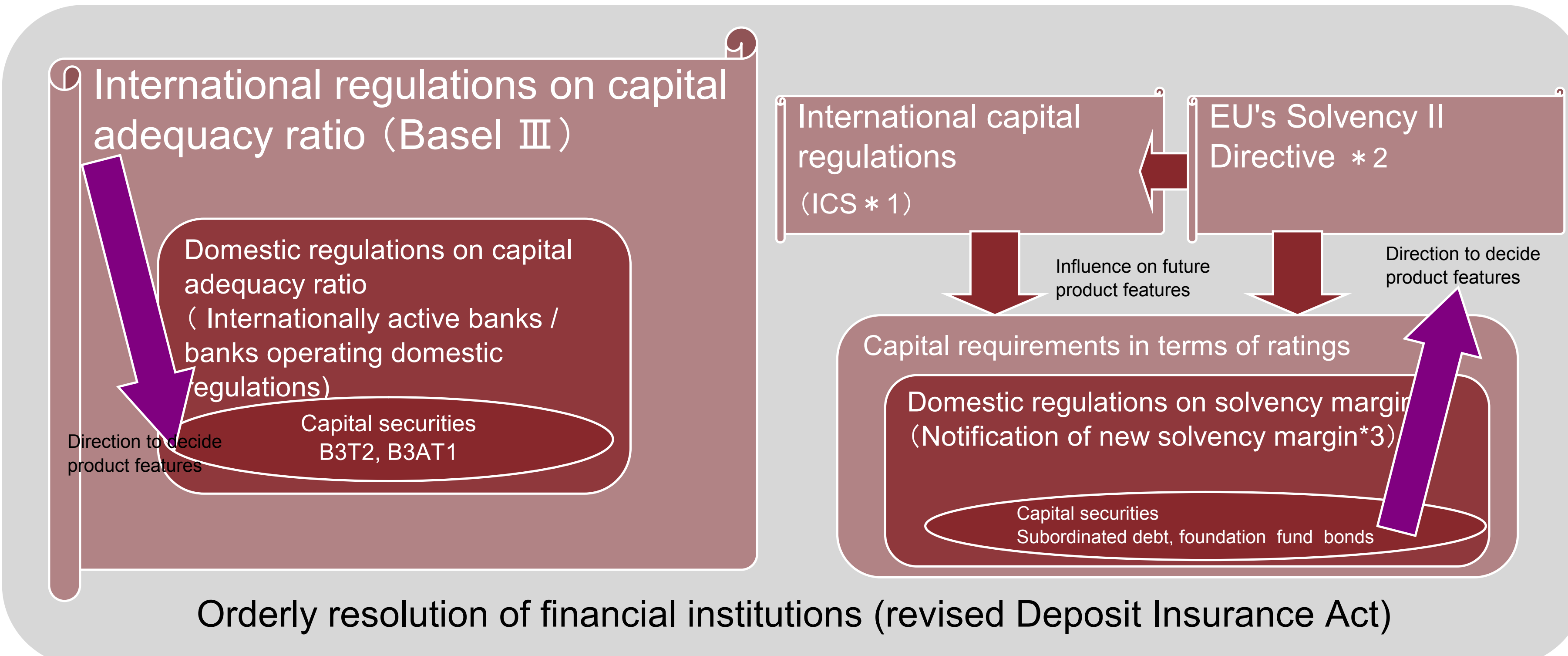
Process to Decide Product Features of Capital Securities Issued by Financial Institutions

■ **Banks⇒ Ready-made securities** ■ **Insurers ⇒ Custom-made securities**

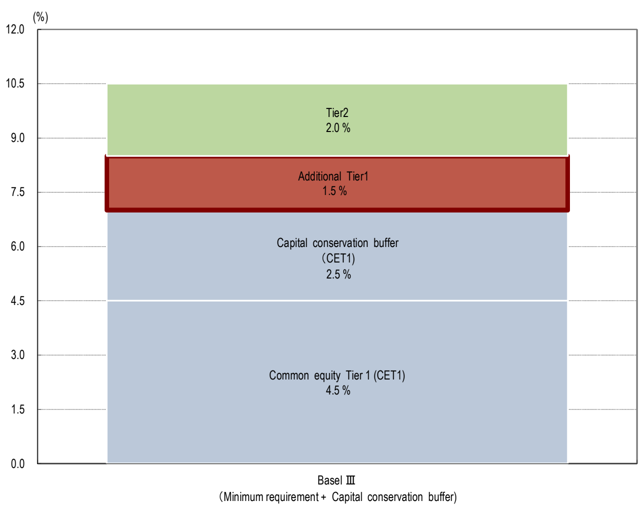


Source: Compiled by Daiwa Securities.
Notes: (1) Move to formulate Insurance Capital Standard by International Association of Insurance Supervisors (IAIS).
(2) EU's Solvency II Directive to be applied from Jan 2016.
(3) Officially implemented in Mar 2012.

3-1. Capital Securities Issued by Banks

■ Basel III-based requirements

Requirements for Capital Adequacy Ratio Under Full Implementation of Basel III



Source: Financial Services Agency; compiled by Daiwa Securities.
Note: Countercyclical capital buffers and capital surcharge for G-SIBs not considered.

Requirements for Tier2 Subordinated Bonds and Additional Tier 1 Capital Securities Under Basel III

	Tier 2 securities (B3T2)	Additional Tier 1 securities (B3AT1)
Maturity date	・At least five years	・No maturity date (Perpetual)
Dividend/coupon	・To be paid, irrespective of credit conditions	・Full discretion for payment cancelation ("Dividend pusher" clause prohibited) ・Non-cumulative ・Within distributable amount
Premature redemption	・Approved from fifth year **・However, special clauses that raise redemption probability (step-up interest rates) not approved** ・Necessitates to maintain sufficient capital and prior approval by Financial Services Agency	
Going-concern loss absorbency	"Benefit of time" not lost in cases other than bankruptcy/liquidation	**・Principle reduction and conversion to common stocks needed at trigger point (CET1 ratio of 5.125% and above)**
Loss absorbency at point of non-viability	**・Necessitates clauses for principle reduction and conversion to common stocks at point of non-viability**	
Priority in payment of residual property	・Inferior to deposits and senior debt	・Inferior to deposits, senior debt, and subordinated debt ・Not included in debt under Bankruptcy Act's insolvency test

Source: Various materials; compiled by Daiwa Securities.
Note: Bold letters indicate changes from requirements under Basel II.

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Basel III-compliant Tier 2 Subordinated Bonds（B3T2）

Point ① Differences with conventional (Basel II) subordinated bonds are (1) granting of principal reduction clau and (2) issuance by bank holding companies

Increase in risk factors to be considered

- ✓ Granting of clauses to absorb losses (principal reduction) from subordinated bonds in case of de-facto failure of issuers
- ✓ Bank holding companies become issuers (due to partial de-recognition of conventional subordinated bonds issued by bank subsidiaries*) * Due to treatment of adjusted minority interest associated with Tier2 capital (Basel III).

Point ② Timing to implement bail-in clauses limited to insolvency cases (in case of Japan

Virtual risk changed little

- ✓ Timing to exercise bail-in clauses limited to insolvency cases
- ✓ Previously, it was concerned that bail-in clauses would be implemented in stage far prior to bankruptcy. But, subordinated bondholders’ risk of incurring losses diminished substantially

Point ③ Japanese rating agencies assign A-category ratings to major Japanese financial groups (BBB-category ratings by foreign agencies)

Rating agencies also support aforementioned opinion

- ✓ JCR and R&I assigned A-category ratings to B3T2 issued by three major banks and Sumitomo Mitsui Trust Holdings

Point ④ Conventional major investors (domestic financial institutions) to hesitate to invest in B3T2

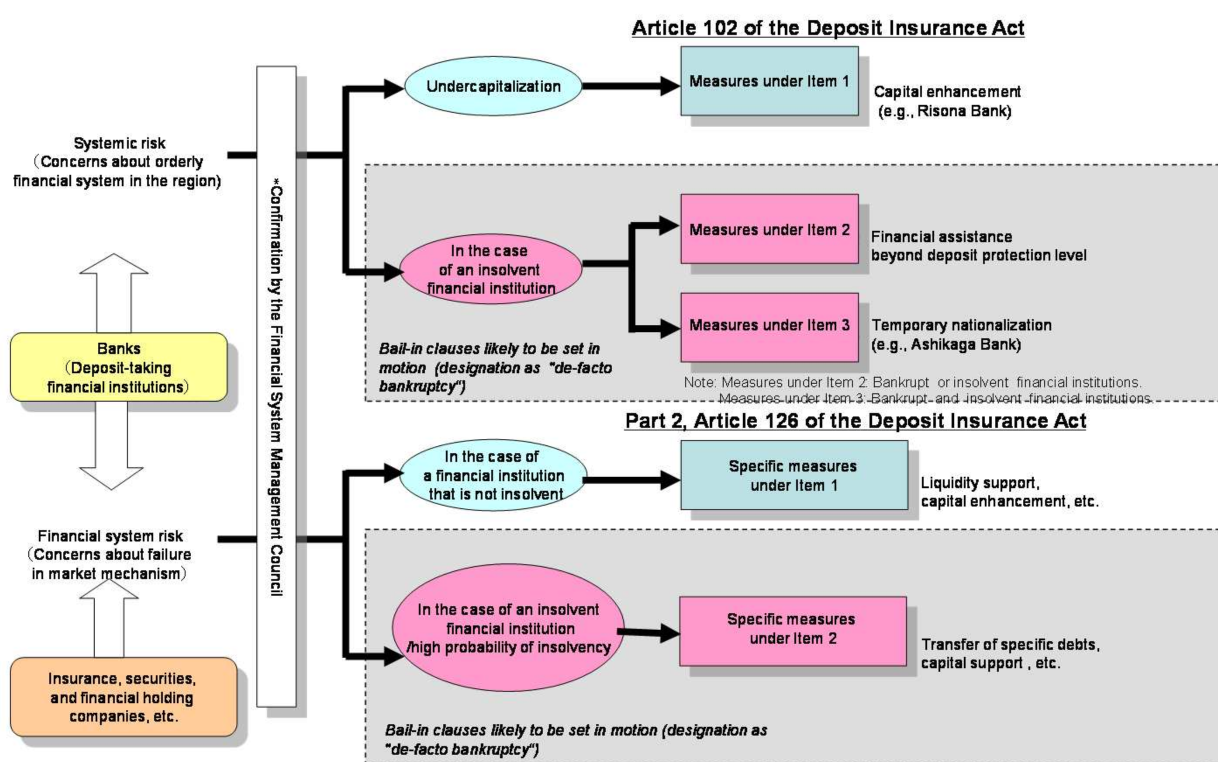
Narrower investor base to serve as chance

- ✓ Due to revision to capital adequacy ratio at domestically operating banks, risk weighting of B3T2 lifted from 100% (for Basel II-compliant subordinated bonds) to 250%

Bail-in Risk Relatively Limited in Japan

- Contractual bail-in clauses
- Basel III-compliant securities have limited bail-in risk
- Preemptive capital injections do not serve as PONV triggers
- PONV triggers occur in case of negative equity

Financial Safety Net Based on Revised Deposit Insurance Act



Source: Financial Services Agency, Proposal to revise Deposit Insurance Act; compiled by Daiwa Securities.

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Ratings of Basel III-compliant Tier 2 Subordinated Bonds（B3T2）

■ **Except for Moody's ratings, no major difference between ratings of conventional (Basel II-compliant) subordinated bonds and those of Basel III-compliant subordinated bonds（B3T2）**

Ratings of Basel III-compliant Subordinated Bonds (actual, forecast)

		JCR	R&I	S&P	MDY
Bank of Tokyo-Mitsubishi UFJ	Senior debt	AA	AA-	A+	A1
	Conventional subordinated bonds	AA-	A+	A	A2
MUFG	B3T2	A+	A+	A-	Baa2
Sumitomo Mitsui Banking Corporation	Senior debt	AA	AA-	A	A1
	Conventional subordinated bonds	AA-	A+	A-	A2
SMFG	B3T2	A+	A+	BBB+	Baa2
Mizuho Bank	Senior debt	AA	AA-	A	A1
	Conventional subordinated bonds	AA-	A+	A-	A2
Mizuho FG	B3T2	A+	A+	BBB+	Baa3
Sumitomo Mitsui Trust Bank	Senior debt	AA-	A+	A	A1
	Conventional subordinated bonds	A+	A	A-	A2
Sumitomo Mitsui Trust Holdings	B3T2	A+	A	BBB+	Baa2

		JCR	R&I	S&P	MDY
Daiwa Securities Group	Senior debt	A+	A	BBB	Baa1
	B3T2	A-	A-	BB+	-
Nomura Holdings	Senior debt	AA-	A+	BBB+	Baa1
	B3T2	A	A	BB+	-

As of Oct. 20th
Source: Methodologies at rating agencies; compiled by Daiwa Securities.

Note: Rating in red circle indicates actual one.

Product Features of B3T2

- Issued by bank holding companies
- Bail-in trigger is simple—when prime minister approves "Special measures under Item 2 under Article 102 of Deposit Insurance Act" (note: actual bonds extinguished on any day within ten days after approval)
- Bail-in clause indicates full principal reduction
- 10-year bullet type, 10NC5 type
- No clause for advance redemption, but there are clauses for early redemption when Tier 2 requirements lost

Basel III-compliant Additional Tier1 Securities (B3AT1)

B3AT1 in forefront in securing soundness at banks

Point ① Going-concern loss absorbency

- ✓ Losses (principal reduction, conversion to common shares) occur when CET1 ratio is 5.125% and lower

Point ② Uncertainty on maturity date

- ✓ Callable perpetual bonds but step-ups not approved

Point ③ Full discretion for coupon payment

- ✓ Non-cumulative coupons, issuer has full discretion on coupon payment

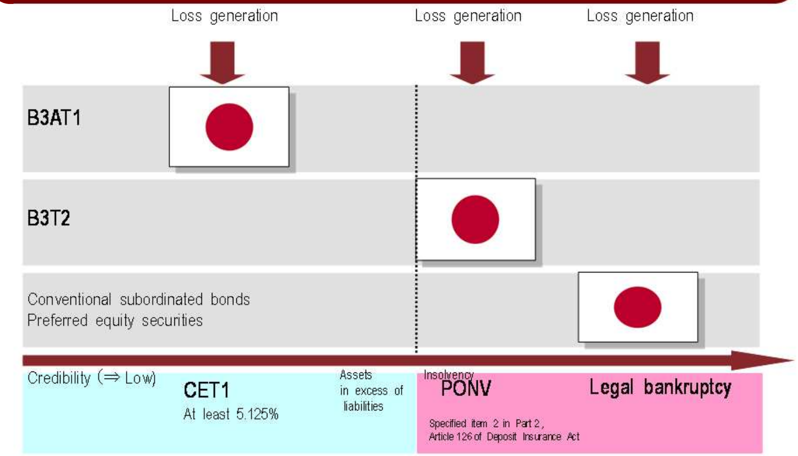
Point ④ Loss absorbency at point of non-viability

- ✓ Similar to B3T2

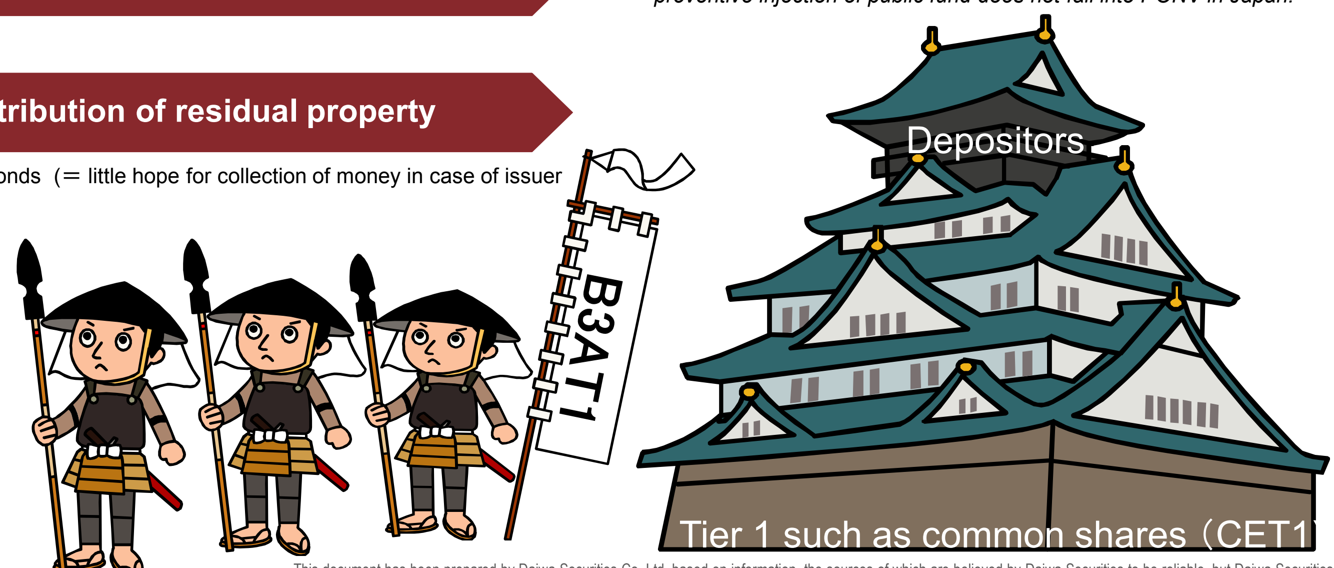
Point ⑤ Inferiority in distribution of residual property

- ✓ Inferior to other debt such as subordinated bonds (= little hope for collection of money in case of issuer entering bankruptcy procedures)

Timing of Loss Generation for Capital Securities



Source: Compiled by Daiwa Securities.
Note: When assets are accepted as being in excess of liabilities, preventive injection of public fund does not fall into PONV in Japan.



Product Features of B3AT1

- **As B3AT1 is regulatory capital in forefront in securing soundness at banks, overall risk exposure increases**
- **Meanwhile, respective L+240bp/L+245bp spreads on A- rated bonds（JCR）attractive**
- **“Bond-like view vs. equity-like view” could be applied**

Product Features of First B3AT1 Issued by MUFG and Mizuho FG

Issuer	Mitsubishi UFJ Financial Group (MUFG)	Mizuho FG
Name	First series of unsecured perpetual subordinated bonds with optional-redemption clause and write-down clause for qualified institutional investors only	First series of unsecured perpetual subordinated bonds with optional-redemption clause and write-down clause for qualified institutional investors only
Term	Perpetual NC5	Perpetual NC5
Issue amount	Y100bn	Y300bn
Coupon rate	**Initial five years: 2.70% (L+240bp)** **After five years: 6-month euro-yen LIBOR + 2.40%**	**Initial five years: 2.75% (L+245bp)** **After five years: 6-month euro-yen LIBOR + 2.45%**
Rating	A- (JCR)	A- (JCR)
① Going-concern loss absorbency	**Partial principal reduction** when consolidated CET1 ratio falls below **5.125%** (Write-down of principal necessary to recover CET ratio to 5.125%)	**Partial principal reduction** when consolidated CET1 ratio falls below **5.125%** (Write-down of principal necessary to recover CET ratio to 5.125%) **※With reinstatement clause (after prior confirmation of Financial Services Agency)**
② Uncertainty on maturity date	Discretionary call option available if five years pass after issuance (on interest payment date) (Note: no granting of stepped-up interest rate)	Discretionary call option available if five years pass after issuance (on interest payment date) (Note: no granting of stepped-up interest rate)
③ Full discretion for coupon payment	Interest payments can be cancelled based on issuer's full discretion (non-cumulative) ・Interest payments should not exceed distributable amount ・With dividend stopper clause (when interest payments on the bonds are cancelled, stock dividend should not be paid	Interest payments can be cancelled based on issuer's full discretion (non-cumulative) ・Interest payments should not exceed distributable amount ・With dividend stopper clause (when interest payments on the bonds are cancelled, stock dividend should not be paid
④ Loss absorbency at point of non-viability	Write-down of full principal when "specified item 2 measures" under Article 126-2 of Deposit Insurance Act are set in motion	Write-down of full principal when "specified item 2 measures" under Article 126-2 of Deposit Insurance Act are set in motion
⑤ Inferiority in distribution of residual property	In case of legal bankruptcy: The bonds rank senior to common shares, pari passu with preferred shares and preferred securities, and junior to general creditors and dated subordinated creditors	In case of legal bankruptcy: The bonds rank senior to company's shares and existing preferred securities issued by its overseas special purpose subsidiaries, and junior to general creditors and subordinated creditors of Tier 2 liabilities of company

Source: Company materials; compiled by Daiwa Securities.

Our Estimates for Ratings on B3AT1

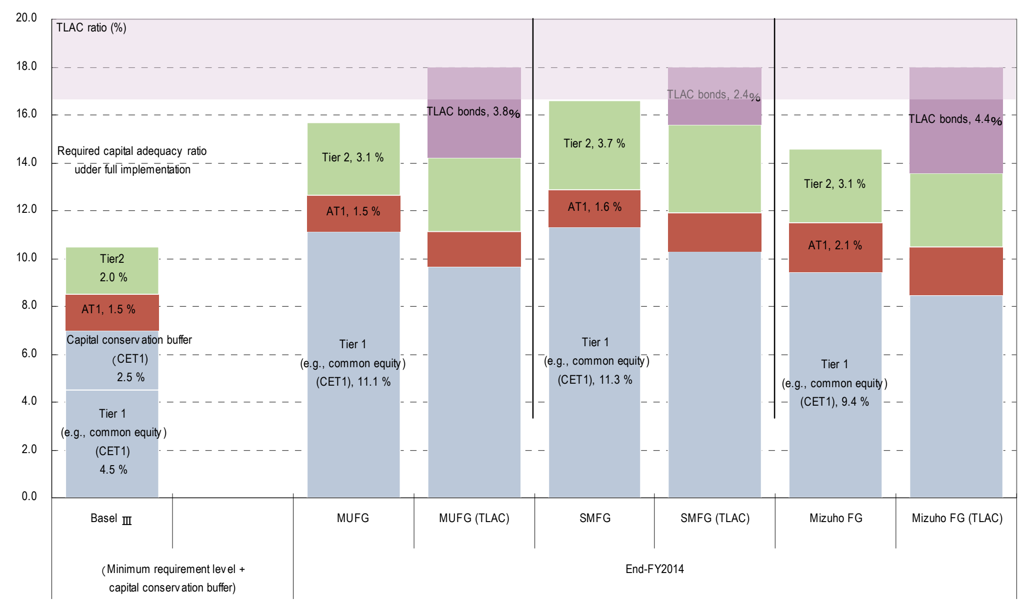
	MUFG	SMFG	Mizuho FG	SMTH
JCR				
Issuer rating (core bank)	AA	AA	AA	AA-
Standard notch-down	3	3	3	3
Notch-down in terms of holding company	1	1	1	-
Total notch-down	4	4	4	3
Rating on B3AT1 (our estimate)	***A-****	***A-****	***A-****	***A-****
R&I				
Issuer rating (core bank)	AA-	AA-	AA-	A+
Standard notch-down	3～4	3～4	3～4	3～4
Notch-down in terms of holding company	1	1	1	1
Total notch-down	4～5	4～5	4～5	4～5
Rating on B3AT1 (our estimate)	***（BBB+ ～BBB）***	***（BBB+ ～BBB）***	***（BBB+ ～BBB）***	***（BBB ～BBB-）***
MDY				
Adjsuted BCA	a3	a3	baa1	a3
Standard notch-down	3	3	3	3
Notch-down in terms of holding company	1	1	1	1
Total notch-down	4	4	4	4
Rating on B3AT1 (our estimate)	***（Ba1）***	***（Ba1）***	***（Ba2）***	***（Ba1）***
S&P				
Standalone assessment	a+	a	a	a
Standard notch-down	3	3	3	3
Notch-down in terms of holding company	1	1	1	1
Total notch-down	4	4	4	4
Rating on B3AT1 (our estimate)	***（BBB）***	***（BBB-）***	***（BBB-）***	***（BBB-）***

As of Oct.20th
Source: Rating agencies; compiled by Daiwa Securities
**Actual rating.*

【Reference】Mega Financial Groups to Issue Senior Debt to Cope with TLAC

- **G-SIBs（three mega financial groups) need to cope with TLAC, in addition to compliance to Base III**
- **Purpose is to have sufficient loss absorbency and avoid usage of public funds in worst case of bankruptcy procedures**
- **They need to issue certain amount of TLAC-eligible debt (TLAC ratio of 16-20%?)**
- **In case of Japan, senior debt issued by financial holding companies can be recognized as TLAC-eligible debt**

Breakdown of Capital Adequacy Ratio at Japanese Mega Financial Groups
(end-FY14 transitional arrangements) **and Estimates for TLAC Requirements**



MUFG：	Slightly above Y4tn
Mizuho FG：	Slightly below Y3tn
SMFG：	Y1.5tn

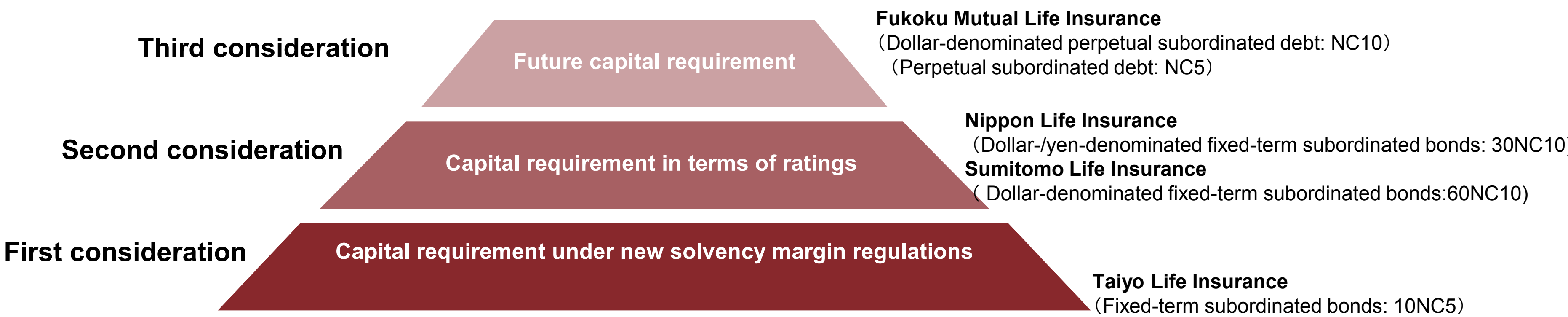
this trigger revival of banks’ senior debt market?

Source: Company materials; compiled by Daiwa Securities.
Note: Capital conservation buffer (2.5%) cannot be included in TLAC, but we assume corresponding amount can be included given deposit insurance system in Japan. As G-SIB surcharge cannot be included in TLAC, we deducted 1.5% for MUFG and 1% each for SMFG and Mizuho FG. Required TLAC ratio assumed at 18%, midpoint of proposed 16-20% range.

3-2. Insurers' Capital Securities (subordinated bonds)

■ Several factors result in "custom-made" product features

- Product design of fixed-term subordinated bonds considers only capital requirements under **solvency margin regulations**
- Specified hybrid debt capital instruments (perpetual subordinated debt) also issued given requirements for inclusion in **solvency margins**
- Issuance of super long-term subordinated bonds also considers requirements in **ratings**
- Some firms prefer perpetual subordinated debt, in anticipation of tighter **regulations in future**



Source: Compiled by Daiwa Securities.

Requirements for Subordinated Bonds Under New Solvency Margin Regulations

Outline of Requirements for Subordinated Bonds Under New Solvency Margin Regulations

	Subordinated term debt	Perpetual subordinated debt	
		Hybrid debt capital instruments	Specified hybrid debt capital instruments
Redemption period	・At least five years	・No limitation (perpetual)	
Dividend/interest payment	・To be paid, irrespective of credit conditions	① Coupon payment can be postponed	① Coupon payment can be postponed ② Coupon payment should be non-cumulative or cumulative, with no limitation on postponement of coupon payment
Premature redemption	・Discretional redemption available by issuers ・Necessitates advance confirmation by Financial Services Agency and sufficient capital holding		
Stepped-up interest rate	Available if five years pass after issuance and rate is not excessive (up to 150bp)	Available if five years pass after issuance and rate is not excessive (up to 150bp)	Available if five years pass after issuance and rate is not excessive (up to 100bp)
Loss absorbency at point of non-viabilit	No loss absorbency		
Cap on inclusion in capital	・Total amount is upper limit of inclusion (within core payment capacity)		All amount can be included
	・Up to 50% of core payment capacity	-	

Source: Financial Service Agency; compiled by Daiwa Securities.
Note: Core payment capacity = Net assets (excl. valuation gains/losses) + Reserve for price fluctuation + Contingency reserve - Net unrealized gains on available-for-sale securities.

$$\text{Solvency margin ratio} = \frac{\text{Total margin amount (incl. equity capital, reserves, subordinated bonds)}}{1/2 \times \text{Total risk amount (incl. risk of increase in insurance claims payment, asset investment-related risk)}}$$

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Criteria for Equity Content Assessment at Rating Agencies

Criteria for Equity Content Assessment at Rating Agencies

Criteria for equity content assessment			R&I	JCR	Moody's	S&P
Equity content assessment			Class 3 50%	Medium equity content 50%	Basket "C" 50%	Medium equity content (cap on inclusion: 25% of capital)
Existence or non-existence of maturity (perpetuity)	Term		Above 50 years (as of issuance)	At least 40 years (residual maturity)	At least 60 years (as of issuance) At least 10 years (residual maturity)	At least 20 years (residual maturity)
	Call option		After five years	After five years	No rules	No rules
	Refinance clause		Necessary	Necessary	Unnecessary	Unnecessary
	Stepped-up	Timing	After five years	After five years	After ten years	After ten years (below 25bp step-up available after five years)
		Degree	Up to 100bp	Around 100bp	Up to 100bp	At least 25bp and up to 100bp
Obligation to continue interest payment	Clause to cancel interest payment		Discretionary cancellation	Discretionary cancellation	Discretionary cancellation	Discretionary cancellation
	Cumulativeness of deferred interest		Cumulative	Cumulative	Cumulative	Cumulative
Ranking of claim (subordination)			Most inferior among debt	Most inferior among debt	Most inferior in capital composition (excl. common shares)	Strong subordination (no clear definition)

Shaded: Most strict standard among guidelines at rating agencies

Source: Rating agencies, interviews with rating agencies; compiled by Daiwa Securities.

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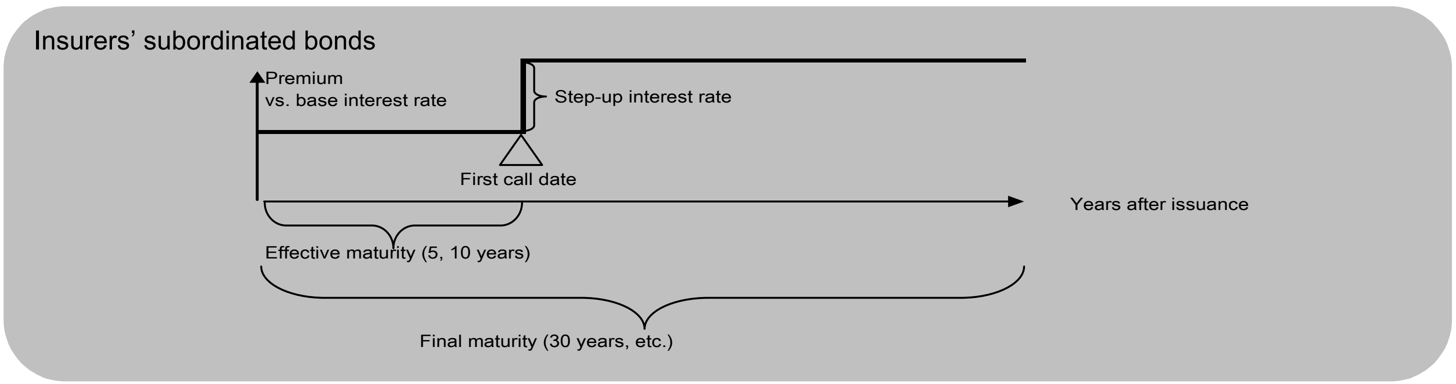
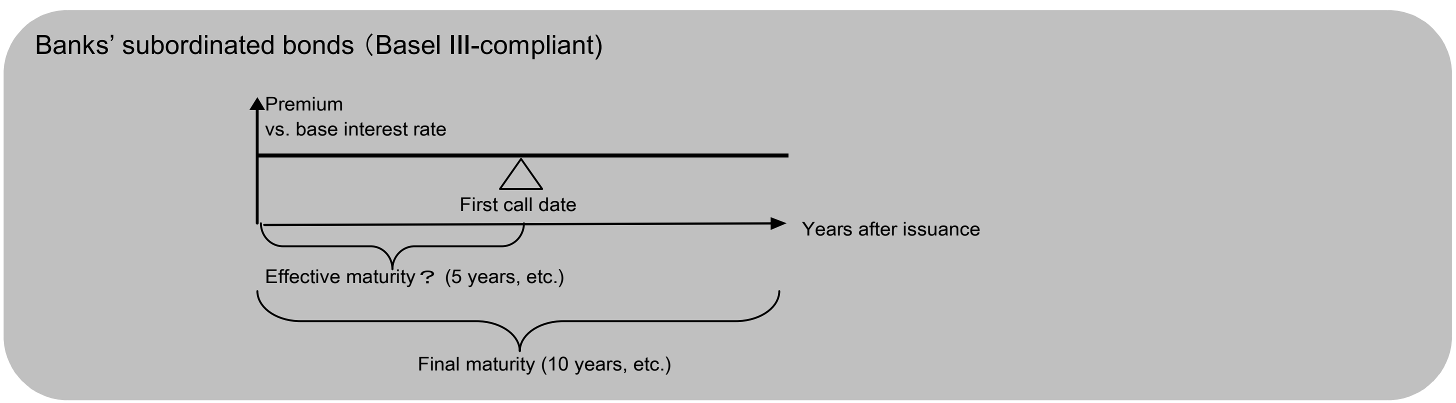
Final maturity tend to be long, but effective maturity shortened by granting callable clauses

- **Due to regulation/rating requirements, final maturity tends to be long**
- **However, issuers shorten effective maturity by granting product feature of callable clauses available when five/ten years pass after issuance**
- **Granted stepped-up interest rate indicates probability of issuer exercising call**

※In case of banks' bonds, granting of stepped-up interest rates (which indicate probability of issuer exercising call) not allowed under Basel III, which is major difference





※When residual maturity becomes shorter than five years, amount that can be included in capital declines, which serves as incentive for issuer to exercise call provision

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Insurers' Subordinated Bonds

■ **Seemingly unattractive investment targets, but practical risks not so high**
■ **Carrying high yields in proportion to inferior marketability and liquidity; attractive amid low-interest rate and tight-spread environment**

Point ① Terms tend to be super long with callable clauses

✓ Because issuers need to consider capital requirements in terms of rating, not limited to requirements for regulatory capital (= solvency margin ratio regulations)

Point ② Redemption risk: Period until first call date can be regarded as effective redemption peri

✓ Unlike banks' capital securities, insurers can indicate probability of call by granting stepped-up interest rates

Point ③ Risk of suspension of interest payment: Low probability of discretionary/compulsory suspension of interest payment

✓ Due to rating requirements, clauses for discretionary/compulsory suspension of interest payment could be granted. However, discretionary suspension is like "nuclear button." Given current business conditions of domestic insurers, risk of compulsory suspension (such as solvency margin ratio less than 200%) limited.

Point ④ Mechanical rating methodology

✓ Two notches down (vs. issuer rating) general, resulting from one notch down due to subordination in collection and one notch down caused by risk of deferral of interest payment

Point ⑤ Substantially factoring in credit enhancement via gov't support is risk

✓ Revision to Deposit Insurance Act enabled preemptive capital injection to insurers. However, we should think that it is possible only in the case of serious market collapse such as Lehman crisis. As witnessed by past bankruptcies of life insurers (Chiyoda, Kyoei, Tokyo, Yamato), gov't unlikely to support firms' failed management.

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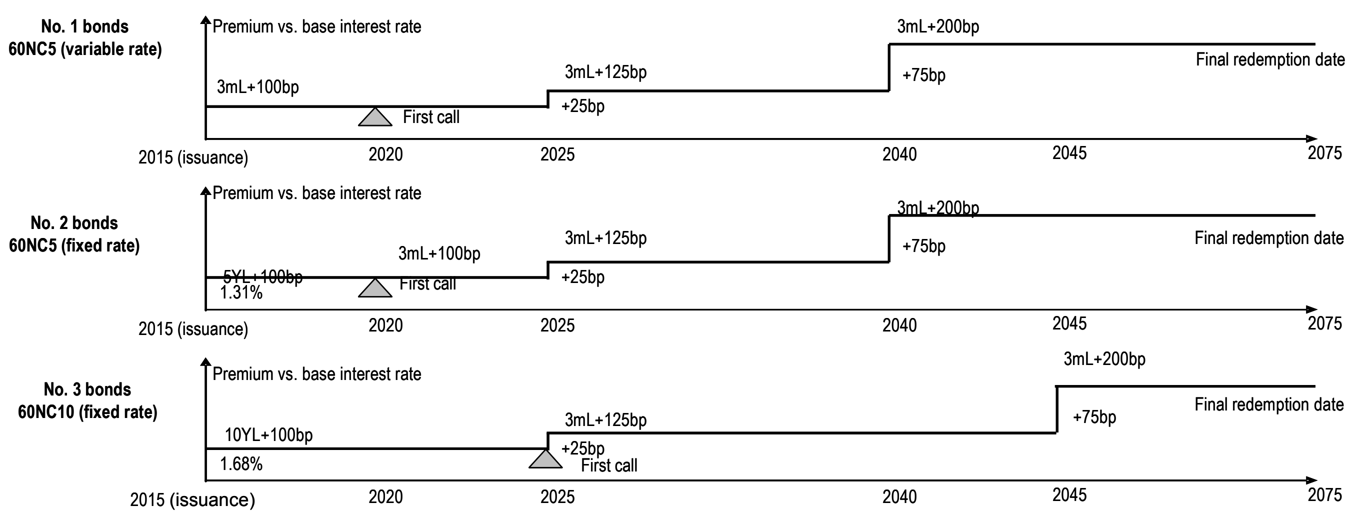
3-3. Capital Securities Issued by Non-financial Firms

Mitsubishi Corporation issued three-tranche publicly offered subordinated bonds amounting to Y200bn

Issuer	Mitsubishi Corporation		
Name	Unsecured subordinated bonds No.1	Unsecured subordinated bonds No.2	Unsecured subordinated bonds No.3
Term	60NC5	60NC5	60NC10
Issue amount	Y68bn	Y92bn	Y40bn
Interest rate	Initial ten years: 3mL+100bp 10-25 years: 3mL+125bp After 25 years: 3mL+200bp	Initial five years: 1.31% (5YL+100bp 5-10 years: 3mL+100bp 10-25 years: 3mL+125bp After 25 years: 3mL+200bp	Initial ten years: 1.68% (10YL+100bp) 10-30 years: 3mL+125bp After 30 years: 3mL+200bp
Rating	A (R&I), A3 (Moody's), A- (S&P)		
① Uncertainty on interest payments	Issuer can defer interest payments at discretion and deferred interest is cumulative (However, accrued and unpaid interest should be compulsory paid by interest payments/dividend on securities inferior to the most preferred stock and subordinated debt ranking pari passu with the bonds)		
② Uncertainty on maturity date	Discretionary call option available if five years pass after issuance (on interest payment date)	Discretionary call option available if five years pass after issuance (on interest payment date)	Discretionary call option available if ten years pass after issuance (on interest payment date)
	Can be redeemed before maturity upon occurrence of tax event or event of equity credit change*	Can be redeemed before maturity upon occurrence of tax event or event of equity credit change*	Can be redeemed before maturity upon occurrence of tax event or event of equity credit change*
⑤ Inferiority in distribution of residual property	In case of legal bankruptcy: The bonds rank junior to priority claims (such as senior debt) and pari passu with the most preferred stock		

Note: Tax event means cases of the bonds not allowed to be included in losses for tax reasons, event of equity credit change indicates cases of rating agencies' changes in standards for equity content assessment (currently 50% at all rating agencies).



Strongly reflecting equity content assessment by foreign rating agencies

Source: Company materials; compiled by Daiwa Securities.

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4. Credit Valuation

Japanese financials

Japan's financial system has been maintaining stability. Financial intermediation has operated more smoothly than before. Extract from BOJ's "Financial System Report, October 2015"

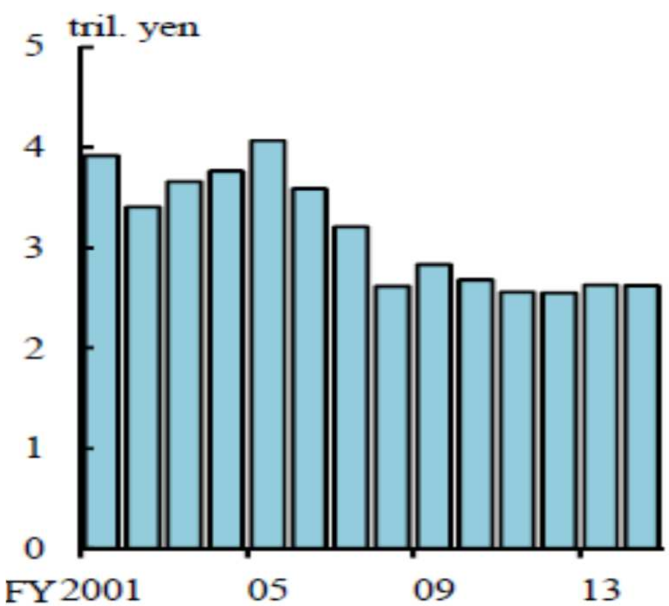
In monitoring Japanese financial system, (1) BOJ's "Financial System Report" (semiannual) and (2) Financial Services Agency's "Financial Monitoring Report" (annual) are useful

Banks

Japanese investors do not worried about credit risk at major banks

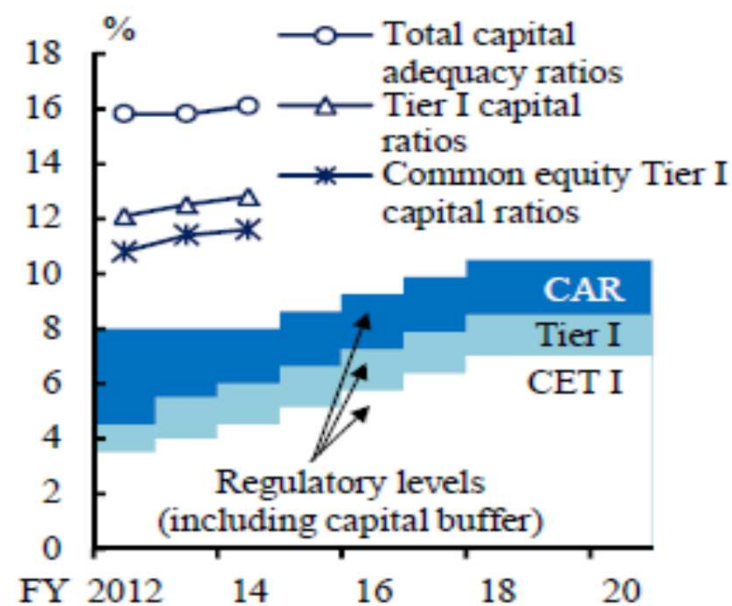
1. **Stable financial system/ solid financial safety net**
2. **Steady earnings**
3. **Adequate capital**

Profit from Core Business (major banks)



Source: Extract from BOJ's Financial System Report, April 2015.

Capital Adequacy Ratios (internationally active banks)



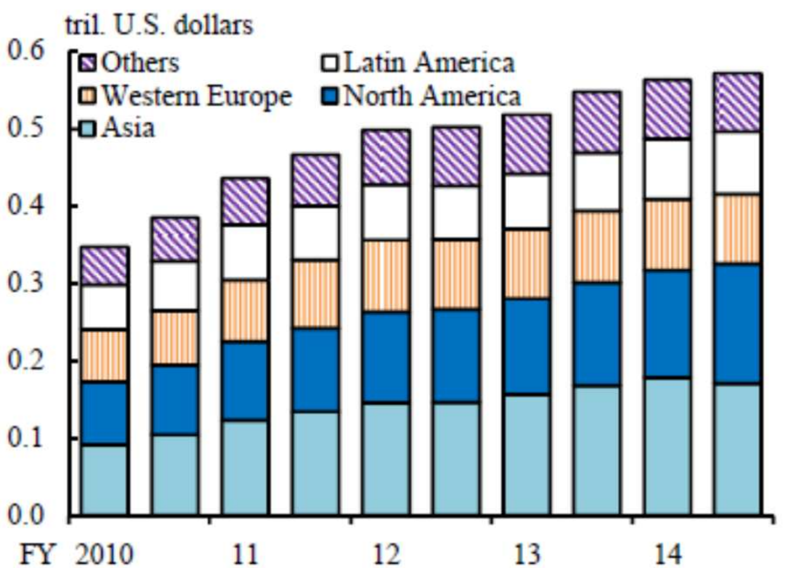
Source: Extract from BOJ's Financial System Report, October 2015.

Focal points in terms of credit risk valuation

Expansion of international operations led to

1. **Deterioration in balance between risk and capital**
2. **Higher risk of foreign currency liquidity**

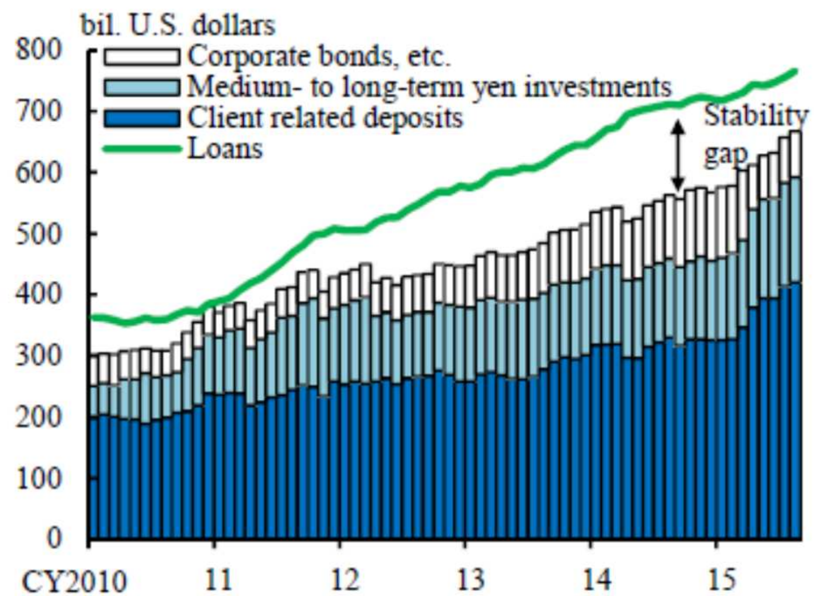
Overseas Loans Outstanding of Three Major Banks



Note: *1*. The latest data are as of the second half of fiscal 2014.
Sources: Published accounts of each bank.

Source: Extract from BOJ's Financial System Report, October 2015.

Stability Gap (Between Illiquid Loans and Stable Funding) Among Major Banks



Notes: *1*. Internationally active banks for major banks are counted. Major bases are counted.
2. The latest data are as of end-August 2015.
3."Corporate bonds, etc." and "Medium- to long-term yen investments" for major banks indicate funding maturing in over 3 months until March 2012 and funding maturing in over 1 year from April 2012. "Corporate bonds, etc." and "Medium- to long-term yen investments" for regional banks indicate funding maturing in over 1 year.

Source: Extract from BOJ's Financial System Report, October 2015.

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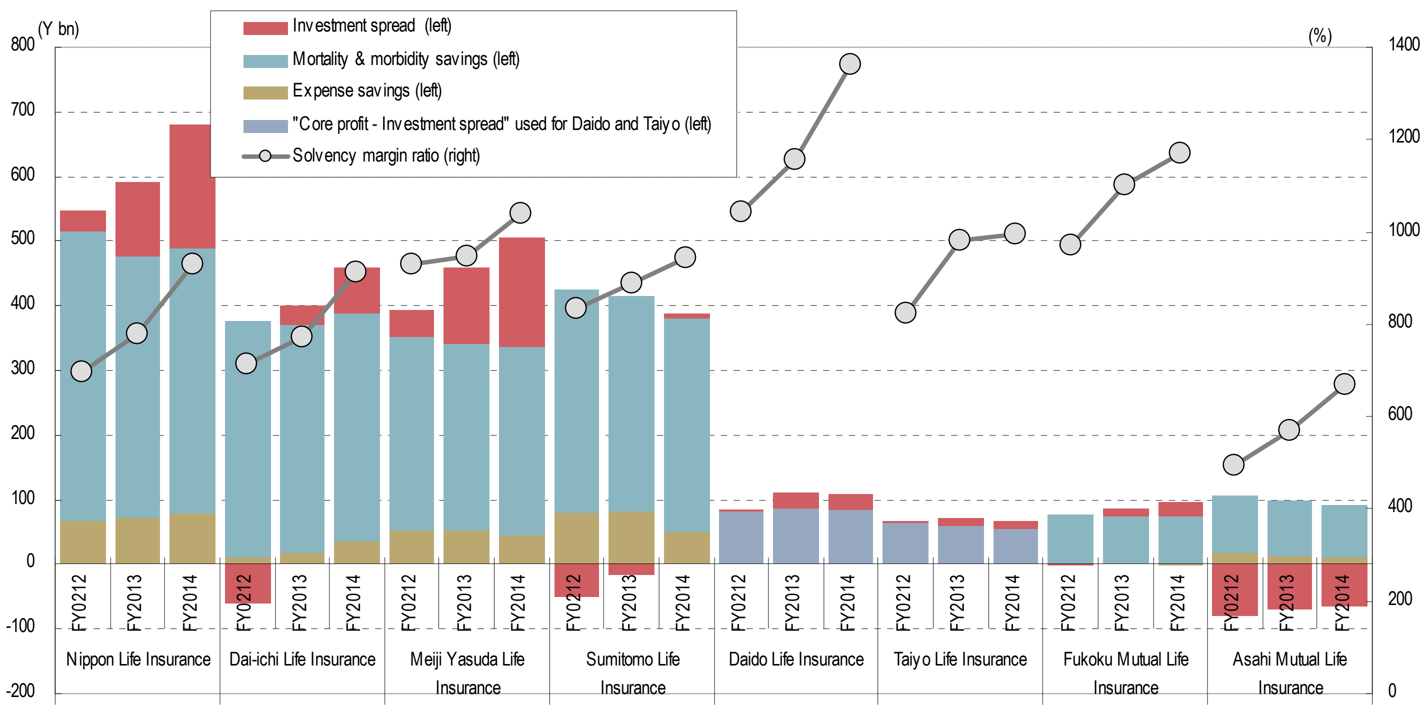
Insurers

Creditworthiness of Japanese life insurers: Stable/improving

1. **Steady core profit driven by improved investment spread**
2. **Improving soundness (solvency margin ratio)**

Core Profit and Solvency Margin Ratio at Major Life Insurers



Source: Company materials; compiled by Daiwa Securities.

Focal points in terms of credit risk valuation

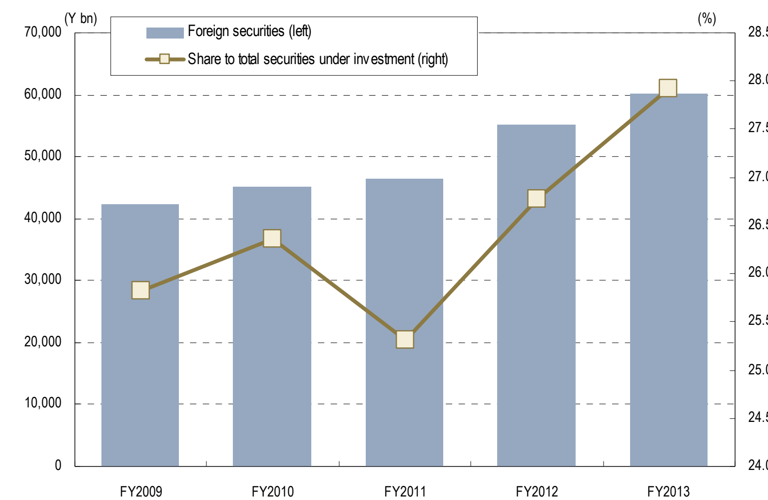
1. Success and failure of overseas M&As
2. Risk control of foreign currency-denominated assets under investment

Recent Investment in Overseas Insurers by Major Life Insurers

	Nation	Company name	Announced in	Investment amount (Y bn)
Meiji Yasuda Life Insurance	US	StanCorp Financial Group	Jul-15	624.6
Dai-ichi Life Insurance	US	Protective Life	Jun-14	582.2
Sumitomo Life Insurance	US	Symetra Financial	Aug-15	466.4
Nippon Life Insurance	Indonesia	Sequis Life	May-14	43.0
Sumitomo Life Insurance	Indonesia	BNI Life Insurance	Dec-13	38.2
Dai-ichi Life Insurance	Indonesia	Panin Life	Jun-13	34.3
Sumitomo Life Insurance	Vietnum	Bao Viet Holdings	Dec-12	28.0

Source: Company materials; compiled by Daiwa Securities.

Investment in Foreign Securities by Life Insurers



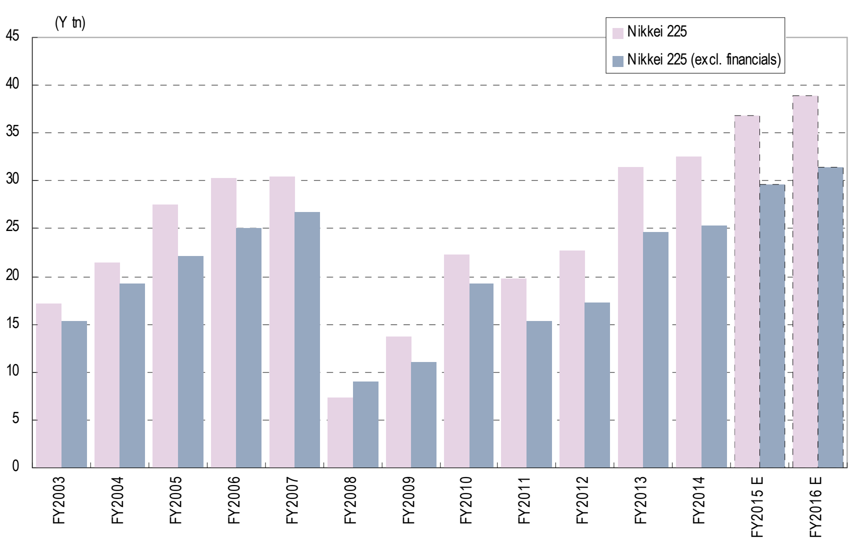
Source: Life Insurance Association of Japan; compiled by Daiwa Securities.

Non-financial Firms

Favorable credit fundamentals at Japanese firms

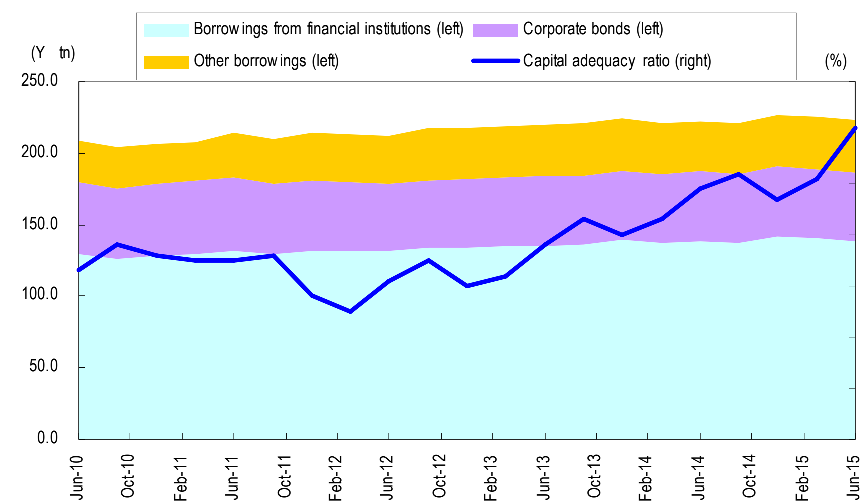
1. Profit uptrend in corporate earnings
2. Healthy balance sheet
3. Credit ratings in upgrade cycle

Recurring Profit at Japanese firms (Nikkei 225 basis)



Source: Nikkei, Toyo Keizai, etc.; compiled by Daiwa Securities.
E: Estimates.

Capital Adequacy Ratio and Financial Debt at Japanese Firms



Source: Financial Statements Statistics of Corporations by Industry (survey targets: companies with capital of Y1 bn or over, excl. financials); compiled by Daiwa Securities.

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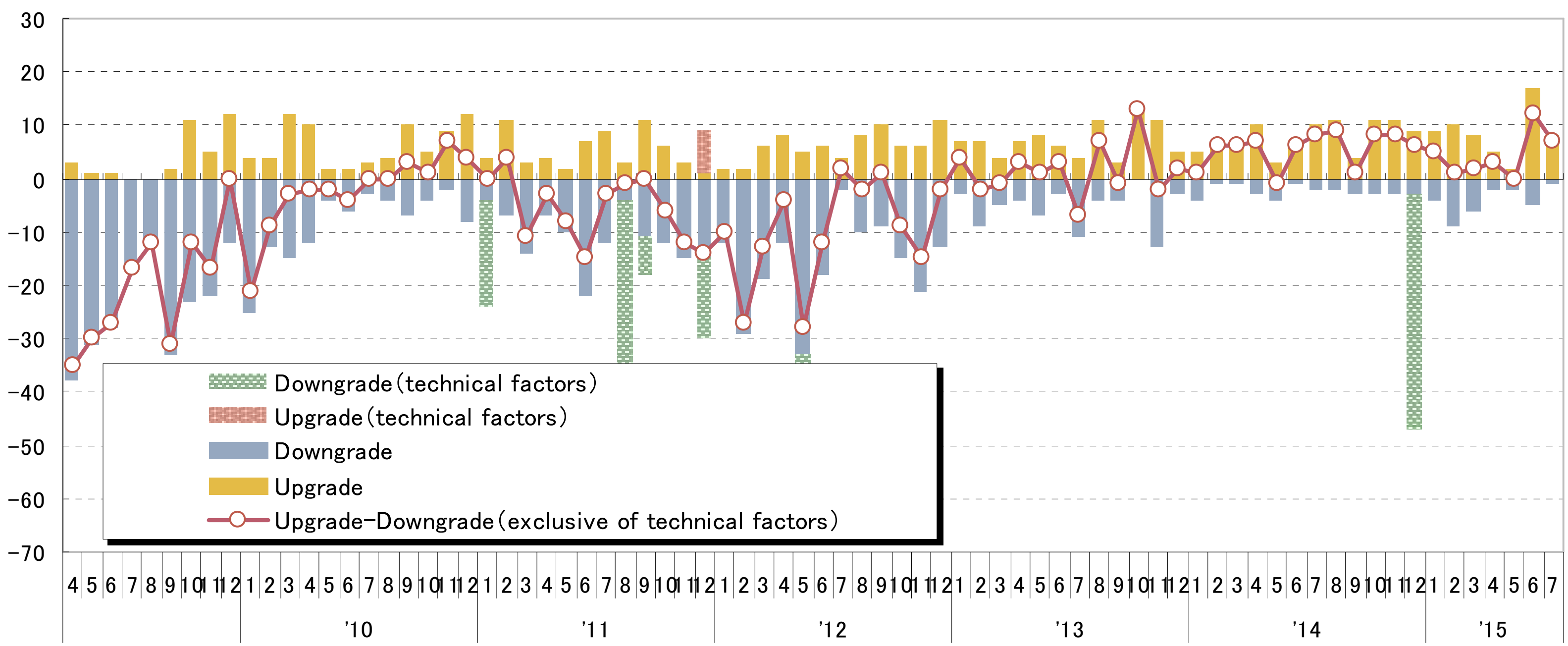
No. of Upgrades and Downgrades



Source: Rating agencies; compiled by Daiwa Securities.
Notes: 1) Universe is ratings of domestic corporations by four major rating agencies.
2) Downgrades expressed as negatives.
3) Technical factors mean rating actions triggered by changes in sovereign ratings and rating agency's valuation methodology.

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Summary

- Japanese firms (banks, insurers, non-financial firms) watching for further utilization/issuance of capital securities

- First, they will likely plan to issue yen-denominated bonds. However, issuance of USD-denominated bonds also expected in the case of (1) limited domestic demand and/or (2) overseas market being more attractive.

- Attractiveness of Japanese capital securities— stable creditworthiness at issuers

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If you decide to enter into a business arrangement with our company based on the information described in materials presented along with this cover letter, we ask you to pay close attention to the following items.
• In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction.
In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
• For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements.
• There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
• There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
• Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

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