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# JCR Solicits Public Comments on Rating Methodology for Group Companies of Corporate Group

Japan Credit Rating Agency, Ltd. (JCR) is considering revisions to its rating methodology "Rating Perspectives for Subsidiary Companies," as described below, and will solicit opinions.

## 1. Outline of Review

JCR is considering replacement of the "Rating Perspectives for Subsidiary Companies," which is the rating methodology for group companies under the umbrella of domestic business corporation groups and financial corporation groups, with a new rating methodology “Rating Methodology for Group Companies of Corporate Group” (this rating methodology) by reviewing the existing rating methodology. If this rating methodology is adopted as a result of the consideration, the existing "Rating Perspectives for Subsidiary Companies" will be replaced by this rating methodology. Regarding the financial institutions and others under the prudential regulation, "Rating Methodology for Financial Groups' Holding Companies and Group Companies" are applied to them, and it will continue to be applied, with some modifications to the wording. This rating methodology shall be referred to when considering issues not mentioned in the "Rating Methodology for Financial Groups' Holding Companies and Group Companies." Regarding group companies with the overseas business corporations and financial corporations as the core companies, this rating methodology shall be applied mutatis mutandis after making necessary adjustments based on the legal and accounting systems of the location of those companies. The term "group companies" as used in this rating methodology refers to subsidiaries, affiliates, and other companies, which JCR considers belong to a specific corporate group from various perspectives, such as capital, personnel, and business relationships.

## 2. Background of Review

In recent years, business environment surrounding companies has been changing rapidly and significantly. Accelerated digitalization, globalization, and further development of a decarbonized society have made corporate groups more diverse. In order to achieve sustainable growth, corporate groups are increasingly seeking to increase the synergy effects of the group as a whole through integrated management by having companies with various functions within the group as group companies. Clear management policies and medium- to long-term strategies as a group are becoming more important than ever before, and governance for diverse business fields and organizations must be more sophisticated. In the process of drastically optimizing the corporate group and its business portfolio, positioning and mission of remaining companies within the group are becoming clearer than ever before. The core company's responsibility for risk management is also becoming stronger than before. In light of these changes in the environment, JCR has decided to review the ratings of group companies under the umbrella of corporate groups.

## 3. Details of Review

Up to now, JCR has adopted a top-down approach in principle for substantive consolidated subsidiaries, i.e., the evaluation of group support is added to the evaluation of the creditworthiness of the corporate group as a basis. This review does not significantly change this basic framework.

The scope of the top-down approach and the evaluation of the likelihood of support to a group company of a corporate group will be revised, and the scope of the group will be considered broader and the likelihood of group support will be evaluated more highly, if certain requirements are met. In response to changes in the environment since 2007, when the current rating methodology was established, there have been many variations in the design of corporate groups, and there are cases where the capital relationship is not so strong, but the companies are strongly integrated in terms of business strategy. Therefore, JCR will evaluate group creditworthiness flexibly according to the actual situation. The key point of the top-down approach is whether a probability that the corporate group will provide support, based on reasonable grounds, is recognized, when the creditworthiness of the group company declines. In recent years, there has also been an increase in strategic support, such as additional investments and loans to the group company or further enhancement of business ties by the corporate group in order to realize the group's strategy. It is also important to consider the diversification of support provided by the corporate group to its group companies.

The degree of likelihood of support by a corporate group to its group company is mainly evaluated based on two axes: the degree of control and involvement, which is an indicator for the effectiveness and mobility of support, and the degree of managerial importance, which is an indicator for the rational necessity to provide support. As a result of the evaluations, if the likelihood of support is judged to be high, the creditworthiness of the corporate group is reflected in the rating of the group company.

If the degree of likelihood of remedial or strategic support by the corporate group is deemed to have changed due to a change in management policy or strategy of the corporate group, or a change in the investment ratio in the future, JCR will flexibly review the application of the top-down approach.

With regard to companies that do not fall under the category of group companies, or companies that are consolidated subsidiaries but their degree of importance to the corporate group is not considered very high, the rating will be assigned based on stand-alone creditworthiness (including the impact and effect of belonging to the corporate group on the company's business and financial bases: stand-alone assessment) as before. However, even for such companies, if the likelihood of remedial or strategic support by the corporate group is recognized to more than a certain level, the creditworthiness of the corporate group may be sometimes reflected.

## 4. Future Plans

JCR will solicit public comments on this matter. Comments will be accepted by e-mail to "Contact Us" on JCR website until July 27. JCR plans to finalize this rating methodology in about one month.

## 5. Individual Ratings Needed to be Revised

If this rating methodology is adopted as a result of the consideration, JCR plans to review the long-term issuer ratings of about 20 companies within this fiscal year, about 70% of which are group companies of financial groups and the rest are group companies of business corporation groups. The review may raise the ratings by about one notch.

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**Draft for Public Opinions**

# Rating Methodology for Group Companies of Corporate Group

## 1. Scope of this Methodology and its Relations with Other Methodologies

This rating methodology is applied to group companies of domestic groups with business corporations as core companies and such groups with financial corporations as core companies. However, for financial institutions and the like under the prudential regulation, the "Rating Methodology for Financial Groups' Holding Companies and Group Companies" (released on March 29, 2019) shall be applied preferentially. Regarding group companies with the overseas business corporations and financial corporations as the core companies, this rating methodology shall be applied mutatis mutandis after making necessary adjustments based on the legal and accounting systems of the location of those companies.

## 2. Long-term Issuer Rating of Group Companies

(1) Main Components of Rating Methodology

There are two methods for assigning a long-term issuer rating to a group company of a corporate group: top-down approach, which uses the corporate group's creditworthiness as a starting point and takes into account the degree of likelihood of future group support; and bottom-up approach, which uses the group company's stand-alone creditworthiness assessment as a starting point and adds the degree of likelihood of group support to this. In principle, JCR adopts the top-down approach for rating of group companies. The term "group companies" as used in this rating methodology refers to subsidiaries, affiliates, and other companies, which JCR considers belong to a specific corporate group from various perspectives, such as capital, personnel, and business relationships.

JCR mainly takes into account the following factors to determine a long-term issuer rating for the group company of the corporate group.

(I) Likelihood of support by the corporate group for the group company
  - i. Degree of Control and Involvement of Corporate Group in Group Company
  - ii. Degree of Managerial Importance in Corporate Group

(II) Stand-alone Creditworthiness of Group Company (Stand-alone Assessment)

(III) Creditworthiness of Corporate Group

(2) Support by the corporate group to the group company

Support by the corporate group to the group company is judged comprehensively based on an evaluations from two axes: degree of control and involvement evaluation and degree of managerial importance evaluation. The key point of the top-down approach is recognition of a probability that the corporate group will provide remedial support, based on reasonable grounds, when the creditworthiness of the group company declines. In addition, it is usually assumed that the corporate group will often provide strategic support such as additional investments and loans to the group company, or further enhancement of ties between the corporate group and the group company, for the realization of the group strategy and sustainable growth. JCR will judge support of the corporate group from the perspectives of both remedial and strategic supports.

(i) Degree of Control and Involvement of Corporate Group in Group Company

The evaluation of control and involvement is based on (i) ratio of voting rights held by the corporate group in the group company, (ii) degree of involvement of the corporate group in the decision-making process of the group company, (iii) status of dispatch of directors and others, and (iv) status of establishment and utilization of group CMS and credit lines or integrity of management control. The higher the ratio of voting rights, the greater the degree of control and involvement of the corporate group, but if the ratio is not 100%, JCR considers the effective controlling power of the corporate group, taking into account the composition of other shareholders.

With regard to listed subsidiaries, they are positioned as leading companies in the corporate group, and their sharing of strategies and business ties are relatively strong. On the other hand, the perspective of ensuring independence is becoming increasingly important amid the increasing demand for more sophisticated group governance, and the degree of control and involvement by a company is highly constrained. Furthermore, for companies that are fifty-fifty joint ventures, the positioning and importance in the two corporate groups in terms of business strategy are not consistent. For these companies, JCR will make a comprehensive judgment of the degree of control and involvement by carefully examining how the group company joined the group or how it was established, current status of governance, and changes in positioning in the two groups.

(ii) Degree of Managerial Importance in the Corporate Group

The degree of managerial importance is evaluated from the perspectives of (i) degree of strategic importance (whether the business segment to which the group company belongs is an important for the corporate group's long-term vision and medium-term management plan) and (ii) degree of functional importance (whether the group company performs important functions in forming the value chain and group infrastructure for business operations). The more important a group company is in the corporate group, the closer the creditworthiness of the group company becomes to that of the corporate group.

(3) Stand-alone Creditworthiness of Group Company (Stand-alone Assessment)

The stand-alone creditworthiness of a group company refers to the creditworthiness of the group company on its own, based on the evaluation of its business and financial bases that have been formed through its relationship with the corporate group (formed by the core company). JCR does not assume a fully independent company with no consideration of ties to the group in terms of people, goods, money, and business. The target of long-term issuer rating is unambiguously the group company. Assuming that the group creditworthiness declines and support cannot be obtained from the parent company and others, or that the group company leaves the corporate group, JCR will evaluate the creditworthiness of the group company alone.

(4) Creditworthiness of Corporate Group

With regard to the creditworthiness of a group company, JCR will evaluate the creditworthiness of the corporate group to which the group company belongs in order to determine the base point for notching down when the top-down approach is applied. With regard to the creditworthiness of a corporate group, JCR basically analyzes the consolidated financial and business bases of the corporate group, but adjustments may be made to the consolidated data in accordance with the actual condition of the group. The creditworthiness of a corporate group can be regarded as the underlying strength that supports its group companies. No matter how strong the degree of control and involvement or managerial importance, if the creditworthiness of the corporate group is low, it will have a negative impact on the degree of likelihood of group support.

(5) Consideration of Approach to be Applied

Through (2) through (4) above, JCR evaluates the likelihood of support by the corporate group to the group company to determine whether the top-down approach can be applied. If possible, JCR determines the rating of the group company by applying notching (difference in creditworthiness between the group and the group company) according to the likelihood of support.

However, during the evaluation process, it may be determined that the top-down approach should not be applied even if a company falls under the category of group companies. For example, the top-down approach may not be applied in cases where the core company is an investment fund and the like, and the group company is a net investment target, and it is therefore easily assumed that the group company will be replaced in the future, even if the ratio of voting rights is sufficiently high.

If it is recognized that the degree of likelihood of remedial or strategic support by the corporate group will change in the future due to a change in management policy or strategy of the corporate group or a change in the investment ratio, JCR will flexibly review whether the top-down approach should be applied.

If the stand-alone assessment exceeds the top-down approach assessment, JCR gives priority to the stand-alone assessment for the rating of the group company. Even in such cases, in principle, the rating level of the group company shall not exceed the group creditworthiness. However, if the influence of the corporate group is judged to be limited due to the fact that the group company is listed on a stock exchange or other factors, the creditworthiness of the group company may exceed that of the corporate group to a certain degree.

For companies that do not fall under the category of group companies or whose importance to the corporate group is not considered at a high degree, stand-alone assessment is the general rule. However, even for such companies, the creditworthiness of the corporate group may be reflected if the likelihood of remedial or strategic support by the corporate group is recognized to more than a certain degree.

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