

Rating Methodology for a Holding Company

This rating methodology applies primarily to a pure holding company which is established as a resident corporation in Japan by an industrial or financial company and its affiliates. It is applicable as well to non-resident holding companies, if and after necessary adjustments are made up to their local legal and accounting systems.

This document constitutes an addendum to “Ratings of Bank Holding Companies and subsidiary Banks” (as announced on March 15, 2001), “Rating Viewpoints on Pure Holding Companies (Domestic Industrial Corporations) (as announced on July 1, 2003) and “Rating Perspectives on an Insurance Holding Company and its Subsidiaries” (as announced on May 31, 2005).

1. Rating Methodology for a Holding Company of Industrial Corporations Group

(1) Base Point of Assessment

As the base point of assessment JCR sees overall creditworthiness of the group (the group rating) to which the holding company belongs. The analysis takes the group’s financial and operational strength on a consolidated basis as its primary object but may allow relevant adjustment to the data when appropriate in light of facts.

The rating to a subsidiary of the holding company also starts with the group rating as base point. JCR then assesses the position of the subsidiary within the group and other facts to determine whether the rating is the same as the group rating or needs to be notched down and how many notches. In general, the group rating makes a ceiling for the rating of subsidiaries. There are, however, exceptional cases where the subsidiary is rated higher than the group rating.

(2) Process of Issuer Rating

In the process of rating an industrial corporations’ holding company JCR puts greatest importance on the group’s total capacity of cash flow generation and the holding company’s control over its group companies (group control of the holding company). It is because JCR believes the holding company can weather a certain degree of its own weakness in stand-alone earnings and financials if it commands a sizable cash flow generated within the group and at the same time an adequate group control. To determine the level of group control of the holding company JCR sees (i) founding purposes of the holding company, (ii) degree of its involvement in the operation of subsidiaries in terms of shareholding and human relations, and (iii) strength of its power and authority over subsidiaries.

In cases where there is no particular concern over the group’s cash flow generation nor the holding company’s group control and besides there is no special issues that suggests otherwise, JCR gives an issuer rating to the holding company of the same grade as the group rating with no notching down. Holding

companies of industrial corporations group in Japan generally have a strong group control, where JCR tends more often than not to assign a rating that is equal to the group rating.

It is notable that JCR checks cash flows of the holding company itself. Holding companies tend to have no earning on their own and hence little capacity of cash flow generation. They may have few assets other than shares of subsidiaries. Thus they would rely their sources of payment for external financial debt on the cash receivable from subsidiaries as commission, dividend, etc. Theoretically, therefore, it is possible the creditors of a holding company may stand in a position subordinate to those of its subsidiaries (structurally subordinate nature of the holding company). Assessment of the holding company's cash flow, on stand-alone basis, enables us to see the probability in which such structural subordination could be materialized as trouble.

In assessment of the holding company's stand-alone cash flows JCR sees the balance between inflows and outflows of cash (cash flow balance). In particular, JCR sees (i) the relative amount of non-dividend revenues among regular sources of cash other than dividend and the reliability of dividend revenues themselves, and (ii) adequacy of cash inflows relative to outflows, among others. JCR uses in reference double leverage ratio (aggregate investment in subsidiaries divided by aggregate parent equity). It represents a group situation in which the holding company resorts to external debt to acquire its subsidiaries' shares when the subsidiaries themselves are externally indebted. It is hence considered as a factor that could induce the holding company's structurally subordinate nature to become an issue. When double leverage ratio is high, in such a way that the holding company has financed its group shareholdings by external debt, so is the probability in which its cash inflows of regular sources other than dividend would not cover debt payment and other cash outflows.

JCR may notch down the holding company's rating from the group rating, when it finds a significant weakness in its stand-alone cash flow balance, after consideration of it in reference to the group capacity of cash flow generation and the holding company's group control.

(3) Process of Issue Rating

When both a holding company and its subsidiaries go bankrupt together, debt collection of the creditors to the holding company cannot but depend much on the liquidating dividend paid by busted subsidiaries. (Note the holding companies usually do not have much asset other than their subsidiaries' shares.) The liquidating distribution is payable only as residuals after preferential payment of debt to the creditors and also after possible deduction in value if there were impairment in those subsidiaries' net worth. This makes an avenue of structural subordination of the holding company being materialized and thereby its creditors now actually suffer subordination in its debt collection to that of subsidiaries' creditors; i.e. they do not find adequate cash for their collection due to their borrower being indebted to buy subsidiary shares (structural subordination in the debt collection).

Therefore, JCR sees the degree of structural subordination in the debt collection, as well as possible senior-subordinate relationship between creditors of the holding company and its subsidiaries in the rating

process for individual issues of the holding company,

The degree of the holding company's structural subordination in debt payment is known by its double leverage ratio. If double leverage ratio is high, i.e. the degree of structural subordination in debt payment is significant, JCR considers notch down the ratings of individual debts of the holding company from the group rating, and it does so when the group rating is low (BB or lower).

In case where a subsidiary's creditors hold collaterals or other ways of preferred status of debt collection, on top of the subsidiary enjoying on-lending of the holding company's external finance, it is considered the holding company is, and in the end its creditors as well are, subordinate to that subsidiary's creditors. JCR duly reflects such structural subordination to individual issue ratings of the holding company as required.

On the other hand, the holding company can offset its structural subordination at the individual issues if it obtains guarantee or other appropriate means of credit enhancement from the relevant subsidiaries. In such cases JCR sees no need to show the holding company's structural subordination reflected as notch down to its individual issue ratings.

2. Rating Methodology for a Holding Company of Financial Corporations Group

The same methodology as described so far applies by and large to the holding company of financial corporations group, i.e. JCR sees at first the group rating as the base of assessment and considers strength of the holding company's group control, structural subordination, etc.

JCR takes into consideration, however, certain industry particulars. For banks, insurance companies and securities companies, etc. (Financial Instruments Business Operators) it is possible for their holding company (Banks, Insurance Companies and Securities Companies' Holding Company) to be restricted by prudential regulation of the Law in receiving dividends from its core subsidiaries. Hence constrained is its command over cash flows of subsidiaries. Resolution policies may apply discriminately to the holding companies from their bank subsidiaries. Whereas banks are entitled, if the case may be, for special resolution schemes under the Deposit Insurance Law, and thereby their creditors receive favorable, or "remedial", treatment in securing their claims, the holding companies are not. It is to be noted that in case of global systematically important banks (G-SIBs) it is possible the holding company's creditors are expected to assume primary responsibility, together with its shareholders, to absorb loss in the resolution as a result of currently contemplated framework of total loss absorption capacity (TLAC). All things considered, JCR expects to find more cases, in which the holding company's structural subordination is reflected as its rating differential from the subsidiaries' rating, in the banks, insurances and securities companies group than in the business corporations group.

If a holding company of banks, insurance companies and securities companies has weakness in its cash flow balance, its vulnerability is of particular concern in the prospect of constraint over its appropriation of subsidiaries' cash flow. JCR considers downward notching of such holding companies from their group ratings, even when it finds good group control of theirs. It is the same, however, as in the industrial corporations group, for JCR to see the strength of group control to determine whether downward notching



from the group rating is necessary in the rating of a given holding company of banks, insurance companies and securities companies, if it finds no problem in the holding company's cash flow balance. As for the individual issue rating of a holding company of banks, insurance companies and securities companies, there may be notching down from the group rating if, as argued in the case of industrial companies groups, the structural subordination is significant and discernible with high double leverage ratio.

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