

## Methodology Used in Rating Public-Sector Entities

### 1. Outline of Methodology

For the rating of government-affiliated institutions such as state-owned banks and enterprises, JCR gauges the strength of their relationship with the relevant government by reviewing if they have legal support, their importance in the government's industrial policy, etc., and judges to what extent the government's creditworthiness should be reflected in their ratings. At the same time, JCR analyzes and assesses the financial position and business risks of such entities to draw the judgment. As a result, ratings on public-sector entities can be equal to or lower than those of the relevant government.

### 2. Key factors in the evaluation

JCR measures the strength of relationship between the public entity and the relevant government from various angles, with attaching importance to the following five factors. Each factor has its own evaluation weight. Basically, JCR considers that factor (a) weighs most among the five factors below, but such weightings are not strictly fixed. When appropriate, JCR may change the weights depending on types and situations of the entities reviewed.

#### (a) Strength of legal protection including regulatory protection

If government protection of a public-sector entity is stipulated under legislation including the law for its inception, that can be a positive factor in assessing the strength of its relationship with the government. Such protection may include, for example, (i) explicit guarantees by law, (ii) government support defined by law, and (iii) laws to provide budgetary support such as operational subsidies, official loans, and interest payment allowances for bond issues.

In addition, the existence of protective governmental regulations can also be a positive factor in evaluating the strength of the entity's relationship with the government. For example, the government can restrict new market entry with a licensing system to control competition in the domestic market. It is also necessary to foresee future of the government's regulatory moves. The forecast takes into consideration matters such as the regulatory authority's policy towards privatization, and the external environment and the existence of social or political organizations which may influence the authority's policies.

#### (b) Strength of government support other than the above-mentioned

It is also necessary to analyze the measures for credit enhancement by way of economic and regulatory supports by the government which do not necessarily have clear legal grounds such as a founding law. Such supports may include: (i) explicit guarantees not based on any legislation, (ii) the government's will to support the entity to fulfill its liabilities in case it falls into a financial difficulty

and (iii) an indirect subsidy and assistance in a broad sense such as creation of a general economic and social environment that can contribute to enhancing the credit quality of the entity. With regard to the government supports other than explicit guarantees, it is important how the government sets up and maintains the overall regulatory, economic and political environment. In that case, it is necessary to analyze whether the government has capacity and will to create a business environment to the future managerial advantage of the entity.

(c) Strength of capital relationship

If the government intends to continue holding an equity stake in a public-sector entity, that can be evaluated positively in assessing its relationship with the government as it may indicate the government's will to maintain its power to control the management of the entity. However, it should be noted that the government's equity holding does not necessarily mean it is fully responsible for the entity's obligation of debt repayment. If the government holds more than 50% of the entity's shares, it is generally considered more likely than not to intervene in its management when it falls into a financial difficulty, as compared to the case where a government stake is less. This may not be the case all the time, however.

Also important is the purpose of government's equity holding. For example, if it is to prevent foreign companies from controlling the entity, it can be expected that the government will promote policies to protect the entity's market and keep its business environment secured. Furthermore, it is necessary to check if the government has plans to privatize the entity or change the shareholding ratio.

(d) Importance in the government's industrial policy

It is necessary to analyze the importance of a public-sector entity in light of the government's national policies including energy policy, industrial policy, social security policy and defense policy. If the entity is given a greater importance, that can be positively evaluated in assessing the strength of its relationship with the government or vice versa.

(e) Strength of personnel relationship with government

A public entity's strong personnel relationship with the government can be positively evaluated in assessing the strength of its relationship with the government. It is necessary to check whether the government participates in the management of the entity, whether it has the power to appoint management of the entity, and when it does, whether there is any legal ground for it.

In assigning the credit standing of a public-sector entity, JCR judges the strength of its relationship with a government by analyzing and evaluating the above-mentioned five factors. However, it should be noted that the entity's strong relationship with the government can be a negative factor from the viewpoint of creditworthiness on the basis of its financial and operating performance. For example, a high government



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equity stake can be an impediment to the entity's efforts to enhance its management efficiency and run its business in keeping with market principles. It can also lead to moral hazard. In addition, a regulation that restricts investment in the entity by foreign companies can be a negative factor in a long-term perspective as it may restrain its overseas fund raising. Therefore, a comprehensive evaluation based on all these factors is required in the final phase of the rating process for a government-affiliated entity.