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Rating Perspectives for subsidiary companies using "Top-down approach"

Japan Credit Rating Agency, Ltd. (JCR) hereby offers the key aspects and overall philosophy concerning the assignment of credit ratings for subsidiaries of parent companies.

1. Background

There are two primary techniques for assigning credit ratings to subsidiaries of parent companies*: the bottom up approach, which concentrates on assessing the subsidiary itself, and adding to such assessments the creditworthiness of the parent company, and the top-down approach, which determines the creditworthiness of the subsidiary based on the creditworthiness of the parent company. When conducting the actual work of assigning credit ratings, JCR reviews which approach to use for each such job. A review of past case histories reveals that JCR has used the bottom up approach more often. This is because JCR has concentrated on the philosophy that parent companies and their subsidiaries are treated as having distinct corporate identities and generally possessing a degree of independence, as well as parent companies being seen as cautious when it comes to support subsidiaries that are lacking in economic rationality and necessity.

In recent times, however, business operations have more strongly adopted policies that emphasize consolidation, and in response, the number of case histories in which JCR has adopted the top-down approach has increased. A forerunner of this trend lies in the lifting of the ban on pure holding companies in 1997. This was followed by a migration on the part of companies to settling company books and information disclosures in a form centered on consolidated results, beginning in the period ended March 31, 2000. Thereafter, laws were enacted concerning business restructuring, and a consolidated taxation policy was also adopted. The number of case histories is also increasing in which companies are applying these policies to their real world operations, in order to improve their competitiveness as corporate groups. Instances of companies turning listed subsidiaries into wholly owned subsidiaries have become particularly noticeable in recent times, as have buyouts through takeover bids (TOBs). At the same time, many companies are taking measures of various sorts to deal with relatively unimportant subsidiaries in the course of identifying and focusing on core competencies. The Companies Act additionally demands that enterprise groups institute internal governance; accordingly, it is becoming increasingly incumbent upon parent companies to maintain appropriate governance while keeping a suitable distance between themselves and their subsidiaries. Parent companies are thus taking on suitable degrees of responsibility for managing risk on the part of their subsidiaries, and are having increasing impact on the creditworthiness of same.

When JCR takes into account the state of such business activities as these, can expect that the number of case histories wherein it is determined that the appropriate thing to do is to apply the top-down approach, which is based on the creditworthiness of parent companies, will increase going forward, rather than the bottom up approach, which concentrates on assessments of subsidiaries themselves. As a consequence, JCR has taken this opportunity to set down the key aspects and philosophy of this top-down approach, as follows:

*JCR uses the actual relations between companies, rather than relying solely on accounting standards, when determining whether companies are in a subsidiary relationship to other companies.

2. The Top Down Approach: Key Aspects and Philosophies

A. Primary Process

Unless otherwise specified, JCR uses the top-down approach when assigning credit ratings to subsidiaries that are effectively consolidated subsidiaries of parent companies. When so doing, JCR makes assessments of the following aspects: a) the degree of control and involvement in the subsidiary on the part of the parent company; b) the strength of the business ties between the parent company and the subsidiary; c) the quantitative component proportion of the overall group that the subsidiary commands; and d) the type and degree of support that can be expected from the parent company in the event that the subsidiary's creditworthiness declines. JCR adjudicates the positioning and significance of the subsidiary, and determine the difference in credit ratings, i.e., the notch difference, between the parent company and the subsidiary, based on this assessment. JCR then determines the credit rating of the subsidiary by way of the top-down approach, from the credit rating level of the parent company and the notch difference between the parent company and the subsidiary.

It is also possible that JCR may decide not to use the top-down approach in the course of the foregoing assessment.

B. Primary Items for Assessment

(a) Degree of control and involvement in the subsidiary on the part of the parent company

JCR believes that when a parent company has policies and procedures in place to strictly administer the business operations of a subsidiary, and wherein the parent company keeps risk under control to the extent allowable, then, the stronger such policies are, the smaller the notch difference between the parent company and the subsidiary. JCR base our determinations on administration and control of subsidiaries by parent companies primarily on such particular criteria as control of shareholders' meetings through proportion of voting rights, parent companies' group administration rules and regulations, state of seconding of executives, and degree of capital involvement and control.

JCR believe that the greater the proportion of voting rights, the stronger the parent company's administration. If the proportion of voting rights is not 100%, review the practical control that the parent company exerts, taking into account the constituency of other shareholders. In such circumstances, JCR verifies, as necessary, such matters as whether or not there are contracts between shareholders, as well as whether or not there are restrictions on transferring shares if the company is not listed on stock exchanges. JCR determines the degree of control, with respect to parent companies' group administration rules and regulations, from the standpoint of such factors as: does the parent company manage risk, and keep risk under control, on the part of the subsidiary equally and homogeneously with the parent company, and do the subsidiary's business plans or investments require the parent company's approval. JCR also determines the degree of control with respect to boards of directors through the constituent proportion of the directors that would be likely to reflect the will of the parent company, such as board members dispatched from the parent company. With respect to seconding of employees to the subsidiary, JCR ascertains the objectives for such seconding, and assess the degree to which such seconding contributes to increasing the control of the subsidiary by the parent company, if any. A further possible factor in these determinations would be capital links and management between the parent company and the subsidiary, such as the degree of participation in cash management systems (CMS) or the state of setting up frameworks for loans by the parent company to the subsidiary.

(b) Strength of Business Ties Between Parent Company and Subsidiary

JCR believes that the stronger the business ties between the parent company and the parent company group (hereinafter "parent company and group") and the subsidiary, and the more significant the position of the subsidiary with respect to the business strategy of the parent company and group, the smaller the notch difference between the parent company and the subsidiary.

JCR conducts our actual assessments in this regard from the standpoint of how essential the business operations and functions of the subsidiary are to the parent company and group. JCR takes into account such factors as the expected extent of negative impact that the parent company and group would

suffer in the event that the subsidiary should cease to exist, or to what extent would impediments be predicted to arise with respect to smooth operation, time, or cost, should the subsidiary be replaced by another company, when determining the importance of the subsidiary and the business ties between the subsidiary on the one hand and the parent company and group on the other.

At the same time, JCR also reviews whether or not there are factors present that would weaken the business ties between the parent company and group and the subsidiary. Specific examples of such factors would include attenuation of relations or synergies between the parent company and group and the subsidiary, and the subsidiary adopting business operations independent of the parent company. JCR also holds similar beliefs to these with regard to situations wherein the parent company frequently acquires and divests itself of subsidiaries, or the involvement of the parent company is restricted from the standpoint of legal regulations or other factors, and exercise caution in making determinations in cases where such situations apply.

When determining business ties between the parent company and group and the subsidiary, JCR also includes future potential as well as past results and present performance in such determinations. Accordingly, JCR determines the strength of business ties based on future strategic positioning when assessing subsidiaries that have had no connection to date with the parent company and group, such as subsidiaries that have been newly established or acquired through buyouts.

(c) Quantitative Component Proportion of the Overall Group that the Subsidiary Commands

In general, JCR believes that the bigger the scope of the business operations of the subsidiary, i.e., as measured by revenues, income, assets, etc., and thus, the greater the component proportion that the subsidiary commands within the parent company and group, the greater the importance of the subsidiary, the tighter the bond between the parent company and the subsidiary, and the smaller the notch difference between the parent company and the subsidiary. Conversely, if the component proportion thereof is small, it becomes necessary to exercise caution in making determinations thereupon, taking other factors for determination into account as well.

(d) Type and Degree of Support that Can Be Expected from the Parent Company in the Event that the Subsidiary's Creditworthiness Declines

JCR believes that if there is a high probability that the parent company will provide support in some form to restore the subsidiary's creditworthiness in the event that such creditworthiness on the part of the subsidiary should decline, then the credit rating of the subsidiary will be close to the credit rating level of the parent company. When reviewing the probability of such interventions, JCR infers the intent of the parent company to offer such support based on such factors as our determinations according to the factors described in a) – c), foregoing. JCR also reviews the fiscal strength of the parent company, and the likelihood of the parent company's being able to actually provide that support, in terms of such factors the degree of support that would be necessary in the event that the subsidiary's creditworthiness declines, the parent company's assets, and the balance of the parent company's ability to obtain capital. JCR determines the notch difference between the parent company and the subsidiary based on these factors of intent and capability to provide support on the part of the parent company.

(e) Overall Determination

JCR makes an overall determination, concentrating on the items covered in a) – d), foregoing, as well as of such factors as the environment for the industry in question, including the regulatory climate and trends on the part of competitors. Based on this overall determination, JCR determines the notch difference between the parent company and the subsidiary, and further determine the credit rating level thereof by way of the top-down approach.

In the event that the credit rating level that is derived from concentrating on the assessment of the subsidiary itself is higher than the credit rating level that is derived from the top-down approach, JCR applies the assessment that is derived from concentrating on the assessment of the subsidiary itself. In such a circumstance, it is conceivable that the credit rating of the subsidiary may exceed that of the

parent company in some cases.

3. Future Operations

Going forward, JCR will operate according to the philosophy described herein when assigning credit ratings to subsidiaries of parent companies, unless otherwise indicated. JCR will promptly re-evaluate already assigned credit ratings in appropriate order so as to conduct assessments thereof according to the philosophy described herein as well.

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