March 15, 2001

Ratings of Bank Holding Companies and Subsidiary Banks

JCR announced its general policies for the ratings of holding companies in the December 1999 issue of its monthly report. Since then, a series of mergers involving major banks have been announced in the banking industry. A number of bank holding companies have also been established, starting with Mizuho Holdings in October 2000, and followed by Mitsubishi Tokyo Financial Group and UFJ Holdings in April this year. Given these changes, JCR will focus in this article on bank holding companies and their subsidiary banks, and will provide a relatively detailed explanation of the policies for rating such entities.

1. Ratings of bank holding companies

(1) Subordination to general claims on subsidiary banks

The scope of operations of bank holding companies is limited to the management of their subsidiary banks and other entities recognized as their subsidiaries (although bank holding companies are permitted to manage securities companies and insurance companies, subsidiaries that operate banking operations will be referred to as “subsidiary banks” in this article, and JCR will focus principally on these subsidiary banks), and other related operations (Paragraph 5 of Article 52 of the Banking Act. That is, bank holding companies are pure holding companies, and are different from business holding companies that can generate income from their operations. Therefore, the main income for bank holding companies is dividends from subsidiary banks (and interest income from loans receivable, if any). As a result, the income (inflows) of bank holding companies is typically very limited.

Needless to say, dividends are the distribution of profits after paying interest. Therefore, subsidiary banks will not pay dividends if they do not pay interest or repay their general payables. In other words, dividends are paid after subsidiary banks repay their general payables. Moreover, because the Banking Act is directly applicable to subsidiary banks, if their capital adequacy ratio falls below the required level, the authority may restrict the payments of dividends, even if the subsidiary banks have no problems with their income level (Article 26 of the Banking Act and ordinance that specifies categories, etc. stipulated in Paragraph 2 of Article 26 of the Banking Act).

Interest income is not subordinate to other ordinary claims, unless it is associated with subordinated loans. To improve the equity capital of subsidiary banks, however, holding companies are unlikely to extend ordinary loans, but will rather offer equity or subordinated loans. As a result, dividends received as a share of the inflows of bank holding companies is considered to be high.

Consequently, the income of bank holding companies is significantly influenced by the financial strength of subsidiary banks and their ability to pay dividends. Moreover, most such income is subordinate to general credits. As a result, it is believed that the ratings of bank holding companies

inherently reflect the structural inferiority in comparison with subsidiary banks.

(2) Cash flow balance

Moreover, JCR believes that when assigning ratings to bank holding companies, it is necessary to analyze estimated real cash flows by examining the balance of inflows and outflows. In other words, JCR believes that an analysis of bank holding companies requires the rating approach adopted for general business companies, in which cash flows are closely examined.

The premises of individual outflows of Japanese bank holding companies appear to vary significantly, and are mainly determined by their individual organizational and operating aspects (expenses), the existence of a public funds burden (interest payments on subordinated loans, dividend payments for preferred shares, and the retaining of earnings for repayments or disposals of the above instruments), and the existence of external debt (repayments of principals).

Inflows comprise dividends and interest from subsidiary banks, and they reflect the profitability and the financial strength of the subsidiary banks. JCR believes, however, that inflows should be assessed in relation to outflows, not simply by their size or stock ratio. This is to say that no matter how big inflows are, if a bank holding company has outflows in excess of inflows, its ratings needs to be more severe.

Meanwhile, the level of double leverage (which means that bank holding companies finance part of the capital participation in subsidiary banks by debt) is generally scrutinized carefully, although this is an issue that comes back to cash flow. In addition, even if debt to be rated is not a specified instrument, such as long-term senior debt, JCR has adopted policies for determining the ratings of the debt by taking into account, to a certain extent, estimated outflows associated with the redemption of the debt.

(3) Policies on actual ratings

This article has explained JCR's policies on the subordination to general claims against subsidiary banks (hereinafter referred to as the "subordination") and the cash flow balance. JCR believes that the degree of actual impact of this subordination on actual ratings depends on the cash flow balance. Consequently, examinations are based on both the quality and quantity of inflows from subsidiary banks. Quality means the stability of dividends, which refers to the likelihood of dividend restrictions and fluctuations in the annual dividend level. The ratings of subsidiary banks are used as a benchmark for determining the level of the quality. Quantity clearly means the dividends and interest income generally expected. Specifically, JCR anticipates the following cases:

(i) Cases when the cash flow balance is not considered to be restricted

These are cases when inflows from highly rated subsidiary banks sufficiently exceed the outflows of the relevant bank holding companies. Because these subsidiary banks have strong, steady profitability,

the issue of the subordination of dividend payments is not necessarily taken into account. In these cases, the subordination also does not become applicable to the rating process. As a result, JCR believes that ratings of bank holding companies will consistent with the rating of the overall group (on a consolidated basis). This means that, under this circumstance, it is possible that ratings of bank holding companies can exceed the highest ratings of subsidiary banks.

(ii) Cases when the cash flow balance is considered to be restricted

These are cases other than (i). They include instances where, for reasons of cash flow balance, bank holding companies depend for part of their inflows on subsidiary banks whose ratings are low, or on subsidiary banks with problems in their cash flow balance despite having high ratings. In these cases, the highest rating of the subsidiary bank in question becomes the ceiling rating for the bank holding companies. The cash flow balance of the bank holding companies is then examined from the perspective of both quality and quantity. The subordination, thereafter, will be reflected in the rating process (by giving a different notch), depending on the degree of reliance on the subsidiary banks and the cash flow balance, in the same manner as the rating process used for ordinary subordinated bonds.

2. Ratings of subsidiary banks

(1) Ratings of bank holding companies and subsidiary banks

As described above, when the cash flow balance is not restricted, ratings of bank holding companies will be consistent with the rating of the overall group. However, subsidiary banks are all independent companies, and can be separated. Moreover, given that subsidiary banks have their own risk profiles, and given that the obligations of mutual support among the subsidiary banks are not legal obligations, it is believed that ratings of the subsidiary banks do not necessarily become ratings of the bank holding companies (the overall group) for the first instance.

With respect to separability, under the holding company structure, it is considered that group (bank holding companies) may dispose of the shares of subsidiary banks (or spin off subsidiary banks) at their own discretion, based on strategic and financial judgments.

In addition, in cases when the consolidated capital adequacy ratio of bank holding companies fall to Category 2 (a non-consolidated capital adequacy ratio of 2% or above, but less than 4% based on the unified international standards, or that of 1% or above, but less than 2% based on the domestic standards in the categories of the adequacy of equity capital stipulated in the ordinance that specifies categories, etc. stipulated in Paragraph 2 of Article 26 of the Banking Act), the authorities may order the bank holding companies to dispose of their shares of the subsidiary banks (Paragraph 17 of Article 52 of the Banking Act and Paragraph 18 of Article 34 of the Enforcement Regulations of the Banking Acts. Taking this into account, the authorities are likely to pay closer attention to maintaining the soundness of the overall group than to intergroup mutual support.

(2) Viewpoints of ratings of subsidiary banks

Taking into consideration (1) above, ratings of subsidiary banks are determined based on an assessment of earnings and the details of the financial situation on a non-consolidated basis. The impact of consolidation (the impact on profits and the complementary impact from the group on credits) is also taken into account, when appropriate.

The impact on profits refers to the positive impact of synergies and the negative impact of consolidation costs. Synergies specifically denote an improvement in profitability anticipated from the expansion of business, product and service lineups, and sales channels, the receipt of mutual operating support, and progress in business restructuring. Consolidation costs include costs in a broad sense that are not directly reflected in profits, such as conflicts and customer services that are added as a result of organizational restructuring, in addition to the actual necessary expenses. This impact on profits is directly or indirectly reflected in the subsidiary banks' profits and in their financial situation on a non-consolidated basis. JCR believes that, at present, it is too early to include the above impact in the ratings of banks that have been part of management integration. Consequently, JCR has adopted policies of reflecting the impact in ratings when appropriate, as it monitors the progress of business performance of the banks against their plans.

JCR believes that the position of subsidiary banks in the group is a key factor in determining the level of complementary impact from the group on credits. This means that because subsidiary banks share common goals of maximizing the corporate value of bank holding companies, it is appropriate to anticipate support for subsidiary banks from the overall group, and mutual support among subsidiary banks.

It is important to note, however, that this support is not stipulated in any laws, and so it is not as binding as a guarantee. In addition, the level of expectation for support is not considered to be as high as that between parent companies and subsidiary companies. As described in (1), because of the separability of subsidiary banks, if the strategic value of a subsidiary bank falls or if it becomes a burden to overall management, it could potentially be spun off from the group. Given this, JCR believes that credit complementary should only have a limited impact on ratings. Specifically, JCR has adopted policies in which, even for a subsidiary bank with a relatively low non-consolidated rating level, if it has apparent strategic value for the group, credit complementary is reflected in the ratings to a certain extent.

Japan Credit Rating Agency, Ltd.
Jiji Press Building, 5-15-8 Ginza, Chuo-ku, Tokyo 104-0061, Japan
Tel. +81 3 3544 7013, Fax. +81 3 3544 7026

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