



R&I's Analytical Approach to Pure Holding Companies

(This report is an English translation of the original report in Japanese.)

- A pure holding company depends on dividends, interest, fees and other income from subsidiaries, particularly its core operating subsidiaries, for its source of cash flow, rather than on income from managing its own business. There also are cases in which funds to acquire a subsidiary's stock are raised through holding company debt. As a rule, under such a structure R&I considers the Issuer Rating of a pure holding company to be subordinate to group creditworthiness. In some cases, however, R&I will evaluate the creditworthiness of a pure holding company and its group to be equal when group cohesiveness is strong.
- Group cohesiveness encompasses the business portfolio strategy for improving the value of the holding company group, and control of the subsidiary that generates the cash flow. R&I emphasize group cohesiveness because strong control over subsidiary cash flow enables the creation of a mechanism for the parent company to quickly receive funds to allocate to its principal and interest payments, even when there are problems with the financial health of the holding company on a standalone basis, such as double leverage.
- Even if the "intention" to maintain the group cohesiveness initially is strong, maintaining cohesiveness will be difficult if the parent company's "fund procurement capacity" is weak. Particularly in cases where the decline in creditworthiness or unhealthy financial position of the holding company on a standalone basis is quite conspicuous, a holding company might decide to sell a subsidiary in order to repay its own or other group company debt or to raise funds. It also is necessary to note carefully the fact that over time, a holding company's approach to maintaining cohesiveness is likely to change.

Pure holding company ratings framework

The following three phases are key steps for evaluating a pure holding company.

- (1) Evaluation of the creditworthiness of the entire group
- (2) Evaluation of the Issuer Rating of the pure holding company
- (3) Investigation of the recovery risk (probability of losses in the event of default) for individual obligations of the pure holding company

"Group creditworthiness" is an evaluation that appropriately incorporates the business and financial risks of the group firms, and forms the basis for ratings of the firms constituting the group. For a pure holding company group, R&I takes such risks into consideration when evaluating the core subsidiary, and normally the core subsidiary Issuer Rating and the group creditworthiness will coincide. On the other hand, a pure holding company relies on the core

subsidiary or other sources to ensure its source of repayment capital, and R&I must judge the strength of group cohesiveness and control over the core subsidiary.

As a rule a holding company Issuer Rating is notched down from the "group creditworthiness"

R&I defines a pure holding company as "a company that does not manage its own business and depends on dividends, interest on loans, fees or other payments from a core subsidiary for its primary source of income." To ensure a source of funds for payment of expenses, redemption of obligations and payment of dividends to shareholders, a pure holding company must create mechanisms that enable it to quickly receive sufficient funds from its subsidiaries. Although this structure is not a problem if the flow of funds within the group is sufficient, there is a possibility risks inherent in the group structure will be actualized if the financial position of the core subsidiary deteriorates.

As an example, let's consider a group comprised of a pure holding company (parent company) and a core subsidiary Company A, whose financial position has deteriorated, resulting in negative cash flow. Company A is the cash flow source for the group. As long as Company A generates cash flow that can support the group and has a sound financial position, there is no problem. What will happen, however, if the financial position of Company A deteriorates severely? Company A will give priority to its payments to external creditors, over payment of dividends to the parent company. While this does not necessarily mean Company A will subordinate payment of parent company interest, fees or other amounts to payments to its external creditors, if it wants to request a change of payment terms this can more easily be fulfilled by approaching the parent company first. Should the pure holding company judge there is little prospect of a recovery as a group, simultaneous bankruptcy with Company A becomes one alternative.

From the standpoint of cash flows, a pure holding company normally is subordinate to its subsidiary's creditors. For this reason, as a rule R&I will assign a pure holding company Issuer Rating that is notched down from group creditworthiness, which reflects the creditworthiness of the core subsidiary.

In some cases, a pure holding company will allocate funds raised through debt to the stock of its subsidiary. In this case, the subsidiary's assets will first be allocated to the subsidiary's creditors if the subsidiary fails. Normally, the subsidiary will be unable to pay the full amount owed to its creditors. Therefore, the value of its stock, which is subordinate to its liabilities, drops to zero. Unless there are other assets, the repayment to the pure holding company's creditors can hardly be expected. As this illustrates, the holding company's creditors are subordinated to the subsidiary's creditors from the perspective of recovery in the event of default as well. R&I expresses the subordination of a pure holding company from the perspectives of cash flow and recovery as the "pure holding company structural subordination."

R&I assigns an identical rating in some cases based on the characteristics of a pure holding company in Japan

R&I occasionally will judge the Issuer Rating of a pure holding company to be equivalent to group creditworthiness. This is because of the possibility, now and in the future, for the parent company to repay its obligations without relying on the subsidiary if it possesses sufficient assets it can use as its own source of repayment funds, such as cash or marketable securities. Given the role of a typical pure holding company, however, examples possessing sufficient assets typically are rare.

Based on factors such as the characteristics of a pure holding company in Japan, R&I might evaluate the holding company Issuer Rating and group creditworthiness to be equivalent as a result of group cohesiveness. With cases in which an existing group will reorganize and introduce a holding company system in particular, there are many actual examples where R&I judged group cohesiveness to be strong and considered the pure holding company and group creditworthiness to be equivalent.

Example of a pure holding company Issuer Rating and group creditworthiness judged to be equivalent

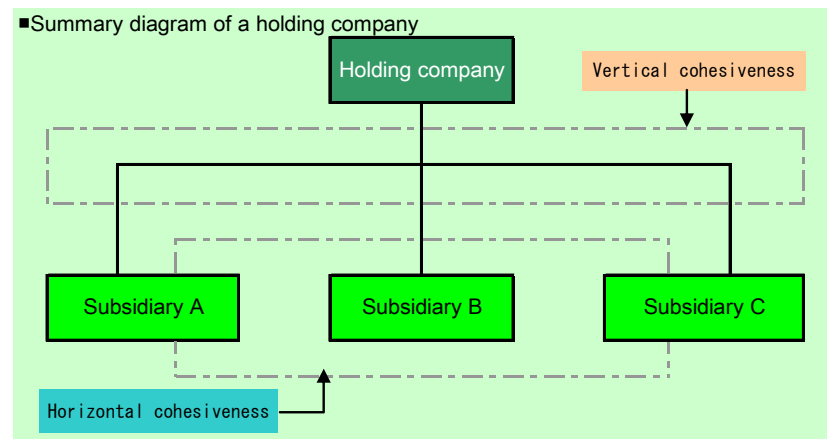
Even if a core subsidiary exhibits substantial cash flow generating capacity, the party that repays the pure holding company debt is always the holding company. R&I will first judge whether the holding company has sufficient control over the core subsidiary by reviewing factors such as personnel relationships as well as decision-making procedures and the proportion of voting rights for critical management issues such as formulation of business strategy, fund raising and financial matters, resource distribution within the group, capital investment and research and development. R&I will then confirm there are no signs the holding company debt is subordinate to the obligations of the core subsidiary company from a cash flow perspective, by examining factors such as the balance between actual principal and interest payments and cash inflow, and measures to ensure alternative liquidity assuming cash inflow is delayed. Based on this information, R&I will judge the strength of the group's cohesiveness. In this analysis, the group includes companies whose existence R&I judges to be a requisite in any situation, such as the core subsidiary that is the source of the cash flow.

R&I can recognize strong cohesiveness when there are strong incentives to maintain group cohesiveness and also there are no serious problems in the holding company financial structure or no concerns regarding the funds procurement capacity of the holding company.

Intention to maintain cohesiveness

To clarify its approach when evaluating cohesiveness, R&I uses the concepts "vertical cohesiveness" and "horizontal cohesiveness." "Vertical cohesiveness" refers to the cohesiveness of the holding company and group subsidiaries, and highlights the extent of holding company control over the subsidiaries. Points for judging "vertical cohesiveness" include the purpose and background for establishment of the holding company, in addition to the holding company's functions, authority, responsibilities, percentage of voting rights and personnel relationships.

"Horizontal cohesiveness" is the cohesiveness among the operating subsidiaries. R&I judges horizontal cohesiveness from factors such as the synergistic effect or business risk diversification effect created by sharing resources, and the strength of the business relationships among the subsidiaries. If sufficient business development is possible based on the subsidiaries' businesses, and there is broad sharing of the brand, technology, know-how, sales organization and other assets and significant added value is achieved by such sharing, this creates a strong incentive for the pure holding company to maintain cohesiveness including the subsidiaries. On the other hand, an alternative approach to diversifying business risk is to combine and hold businesses having a low correlation. This has the advantage of maintaining the subsidiaries even if the extent of business resource sharing is low. In this case, it is important for the subsidiaries to earn their returns commensurate only to their risk. This is because the weak business relationships make it possible to consider any subsidiary as a candidate for sale when reviewing strategy. In particular, a firm that adopts this group structure can review its business strategy as appropriate and adjust the positioning of subsidiaries as its strategy changes, even for a subsidiary evaluated once to have strong cohesiveness.



For judging a pure holding company's intentions concerning cohesiveness, the background for establishment of the holding company structure and its purpose are key points. In contrast to Europe and the U.S., where establishment of a pure holding company often focuses on "suitability as an organizational form for pursuing an M&A (corporate merger and acquisition) strategy" and "ability to pursue tax advantages," holding companies in Japan frequently are established with the objective of "accelerating decision making." The purpose is to optimize the business portfolio and strengthen earnings capacity and competitiveness at minimum time and cost, rather than simply merge. Compared to a group formed through M&A, R&I will judge the cohesiveness of a pure holding company and group to be stronger in the case of an existing group that reorganizes and splits off its operating divisions into separate businesses. If a split off was undertaken with an intention such as selling a division in the future or severing risk, however, cohesiveness will be weakened.

A model noted frequently in recent years when companies have integrated their management is one in which firms first establish a joint holding company as the parent of their respective operating subsidiaries, which they then merge and reorganize at a later date. In many cases R&I judges the cohesiveness of the holding company and group resulting from this "alternative to a straightforward merger" to be strong.

Over the medium to long term, the number of European and American-style pure holding companies has been growing. R&I has already pointed out that as firms establish financial conglomerates, financial holding company groups in Japan have intensified moves that signify aggressive M&A, and R&I has released information on its approach to ratings in response to this trend.

If a core subsidiary provides a guarantee or collateral for the separate debt of the pure holding company, or if there are provisions to the separate debt of the pure holding company that restrict sale of the core subsidiary, R&I can consider cohesiveness to be strong. The reason is that these conditions enable R&I to confirm the legal binding force and the intent of the core subsidiary to pay the parent company's debt. However, careful attention is required on this point, because guarantees or agreements pertaining to the separate debt will become ineffective when the subject debt is redeemed.

Basic approach to ratings of financial holding companies

(1)	As a rule, R&I will notch down a financial holding company Issuer Rating from group creditworthiness. If exceptionally double leverage does not exist, or if the extent of double leverage is small and the holding company has a clear schedule to eliminate the double leverage in a short period of time and also the probability of increasing leverage in the future is low, R&I will assign a holding company rating that is identical to group creditworthiness except in the situation described in (2) below.
(2)	For bank holding companies, when R&I has assigned the subsidiary bank a rating in the BBB zone mainly because of public support, R&I will notch down the holding company rating regardless of whether double leveraging has occurred, based on the possibility of differences in the public support for the bank holding company and subsidiary.

Ability to maintain cohesiveness

R&I must judge a pure holding company's ability to maintain cohesiveness. This is because the tendency to sell off strong subsidiaries increases, and consequently group cohesiveness weakens, when the holding company's financial health is inadequate or there are concerns regarding debt repayment or fund raising by the holding company or other group firms. R&I will judge this ability based on a financial analysis of the holding company on a standalone basis and the level of the group creditworthiness. In many cases, R&I will judge cohesiveness to be strong if group creditworthiness is high and there is little concern of problems occurring with debt repayment or funds procurement, and R&I can discern sufficient intent. There also are times when R&I will investigate the subordination depending on the financial condition of the holding company on a standalone basis, however, when group creditworthiness declines.

In many instances when a holding company is established, the group fund raising functions

are centralized in the holding company, which lends the necessary funds to the subsidiaries. If the holding company fund procurement amount matches the amount of loans to the subsidiaries, R&I can confirm the principal and interest from the subsidiaries will be allocated as the source of funds for the holding company's principal and interest payments. Not all cases are so straightforward, however, and R&I will verify the circumstances from the financial indicators.

A typical indicator R&I uses to judge the financial condition of a holding company on a standalone basis is the double leverage ratio. Double leverage refers to circumstances in which the holding company allocates funds procured through borrowings or bonds to the subsidiary company stock, and the subsidiary also procures funds using external debt, with the ratio being determined by dividing the subsidiary company stock on the holding company balance sheet by equity capital. When this indicator exceeds 100%, it means the holding company depends on dividends from the subsidiary for part of the holding company's funds for debt repayment, and indicates a concern that as a shareholder there is recovery risk that will subordinate the order of recovery to the general creditors of the subsidiary.

Even if not invested in subsidiary stock, when holding company debt is diverted to assets with low liquidity that cannot be expected to generate fixed income, such as cross-holding of shares or the corporate headquarters building, the financial structure of the holding company cannot be deemed sound. R&I confirms the type of assets in which a holding company has invested the funds it has raised, and whether there is a possibility for such assets to be converted into cash.

Even if a holding company's intention and ability to maintain cohesiveness are strong at the time R&I assigns a rating to the holding company, R&I considers the probability of the double leverage ratio increasing over the medium to long term to be high when a holding company intends to pursue an active M&A strategy, and in some cases will not assign a rating that is equivalent to group creditworthiness.

Laws and regulations to strengthen subordination of holding company debt

In general, the purpose of regulations and monitoring or public support for banks is to protect depositors and maintain orderly credit conditions, and there is little need to extend protection to the creditors of a holding company that does not administer a banking business. Consequently it is necessary to consider the possibility the government will provide relief only to a subsidiary bank and the probability of restrictions on a subsidiary bank's payment of dividends.

Depending on laws and regulations, in some instances a subsidiary company is treated preferentially. In the case of life insurance companies, in addition to the provisions of the Insurance Business Law recognizing the preferential rights of the insurance obligations of life insurers, insurance holding companies are obligated in fact to protect the policyholders of their subsidiaries and subordination of the holding company's debts is recognized.

Differences among individual debt ratings also reflect holding company and group company financial structure

After deciding a holding company Issuer Rating, R&I will investigate the recovery risk of individual obligations (probability of losses in the event of default). R&I judges the recovery risk of individual obligations based on considerations such as (1) effect of holding company structural characteristics, (2) evaluation of holding company asset quality, (3) ratio of holding company and subsidiary senior debt and (4) existence of credit enhancement for holding company debt based on an agreement or other arrangement.

Insurance holding company ratings

R&I's thinking concerning insurance holding company ratings is shown below.

In addition to the structural subordination of debt at an insurance holding company, there are system factors that subordinate the holding company debt to the debt of the insurance subsidiary at the center of the group.

Under the provisions of the Insurance Business Law and other regulations, insurance holding companies are obligated in fact to ensure protection of their subsidiary's policyholders. Unlike a bank holding company group, capital requirements and other supervisory regulations are applied only to the insurance subsidiary of the holding company. Authorization from the Prime Minister is necessary to establish a holding company and serve as the principal shareholder, however, and when it recognizes there is a special need to ensure an insurance company's management is sound and appropriate and to protect policyholders, the government can conduct an on-site inspection of the shareholder. An insurance holding company must enhance the insurance claims paying ability of its subsidiary even as it strives to maintain appropriate capital as a group, and it is appropriate to consider a holding company cannot ignore its insurance subsidiary if the subsidiary is faced with an operating crisis.

Furthermore, when the insurance subsidiary is a life insurance company, the preferential rights of the insurance obligations of the life insurer are provided in the Insurance Business Law.

Basic approach to ratings of insurance holding companies

(1)	(1) As a rule, R&I will notch down an insurance holding company Issuer Rating from group creditworthiness. If exceptionally double leverage does not exist, or if the extent of double leverage is small and the holding company has a clear schedule to eliminate the double leverage in a short period of time and also the probability of increasing leverage in the future is low, R&I may assign a holding company rating that is identical to group creditworthiness.
(2)	(2) For life insurance holding companies, R&I will notch down the holding company rating from group creditworthiness regardless of whether double leveraging has occurred, because preferential rights are given to policyholders under the Insurance Business Law. When double leveraging has occurred, R&I will expand the width of the notch down.

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