



R&I's Analytical Approach to Financial Conglomerates

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

1. The Framework of Rating Evaluation

The main steps for R&I's evaluation process concerning corporations that comprise a financial conglomerate consist of the following three stages:

- (1) Evaluation of the creditworthiness of the entire group
- (2) Evaluation of cohesiveness with the group
- (3) Evaluation of the risks for individual obligations of each corporation (the holding company, and subsidiaries under the group umbrella).

The overall creditworthiness of the financial group is determined by aggregating the evaluations of the operational and financial basis of the main financial business affiliates under the group umbrella, which are weighted proportionate to their significance in the group. The synergy effects and risk diversifications achieved by the formation of the group are also taken into consideration. This is called the "Group Creditworthiness," and in general, the rating for the core corporation within the group is consistent with the Group Creditworthiness. As risk characteristics inherent in banks, insurance companies and securities firms differ, it is necessary to evaluate their respective risks appropriately.

Evaluation of the cohesiveness of the group involves two perspectives: 1) the cohesiveness of the holding company with the group ("Vertical Cohesiveness"), and 2) the cohesiveness among the group affiliates ("Horizontal Cohesiveness"). "Vertical Cohesiveness" refers to the control of the holding company over the group subsidiaries, while "Horizontal Cohesiveness" refers to the group cohesion resulting from brand sharing, transaction relations, and synergy effects among the affiliated companies. Companies which comprise the group are evaluated on the basis of their cohesiveness with the group, including their strategic significance in the group, and the results will be reflected in the rating.

The basic framework is not different from those applied to corporate groups. However, financial institutions are subject to regulation and supervision by the regulatory authorities, which may affect the cohesiveness of the group. In addition, as banks have a large impact on orderly credit conditions and settlement systems, the level of public support extended to banks differ significantly from that extended to other types of financial institutions. Therefore, determination of the scope and level of the public support will be important.

There is a correlation between the level of (1) creditworthiness of the entire group, and (2) the group cohesiveness. In general, as the Group Creditworthiness deteriorates, the tendency to seek for cash through sale of healthy subsidiaries gets stronger, increasing the need to evaluate the creditworthiness of individual corporations separately.

2. Rating of Financial Holding Companies

2.1 Emphasis on the Control of Subsidiary Cash Flow

When assessing the credit repayment capacities of financial institutions, cash flow analysis will not have a significant meaning compared to other corporates, and the soundness/liquidity of the assets and the funding capacities will be important. However, for a holding company, the sources of funds for repayment are the interest and dividend income from the subsidiaries and the holding company must secure sufficient cash flow to cover its expenses, funds for repayment of debt, and payment of dividends.

If there is a risk that sufficient cash flow cannot be secured, the Issuer Rating for the holding company will be lower than the Group Creditworthiness (notched down). It is important that the dividend payment and debt repayment by the holding company stay within a reasonable scope in comparison to the profitability of the subsidiaries. In addition, the main functions and authority/responsibility of the holding company will be determined on a substantive basis, and the management policy of the holding company management as well as the financial soundness of the holding company on an unconsolidated basis will be reviewed. Measures taken by the supervisory authority will also be an important evaluation item.

2.2 Bank Holding Companies

2.2.1 Financial Structure and Financial Strategies of the Holding Companies

Where a state of double leverage exists due to the financing of the equity of an affiliate with debt (affiliate shares, etc./holding company capital >100%), the parent company may not be able to sufficiently cover the principal and interest repayment for the obligations it incurred for the investment through dividends and other income from the subsidiaries. In the event a subsidiary becomes insolvent, the claims of holding company creditors on the group's major assets will in fact be subordinate to the claims of the creditors of the subsidiaries. These points must be reflected in the Issuer Rating of the holding company, and the need arises for notching down from the rating of the core subsidiary bank that represents the Group Creditworthiness. Confirmation of not only the double leverage ratio at a certain point of time, but also of the management attitude and financial operations policy is important. For example, if a bank intends to form a financial conglomerate, and converges to a financial holding company group format for the purpose of actively engaging in M&A, the Issuer Rating of the holding company must be notched down from the core subsidiary bank's rating.

Following factors are believed to influence the tendency of bank holding companies to become doubly leveraged.

- (1) Major banks are aggressively rebuilding their business portfolio through acquisition of securities firms and non-banks, etc.
- (2) There is more emphasis on shareholder value, which is leading to tendencies to fund investments through debt rather than equity.
- (3) Bank management tends to protect the financial soundness of the subsidiary bank at the cost

of financial affairs of the holding company.

On the other hand, if both of the holding company and the subsidiary bank are deemed to have sound financial conditions and without intention to use leverage, there is no need for notching down. However, if there is a problem with the financial soundness of the subsidiary bank, there is a likelihood that an investment in the subsidiary will be made through external funding; therefore, such risk should be reviewed taking into consideration the creditworthiness of the holding company. In addition, if public funds have been injected, the level of double leverage may rise in the process of repayment, so it will be important to confirm its financial management policy.

As an exception, a holding company may not be notched down where double leverage exists for the purpose of recapitalization of an affiliated bank, if a policy to raise all necessary funds for the recapitalization in the group and without external funding can be confirmed. This is a rare exception applied only where it is certain that such policy will be maintained solidly throughout the future, and if it becomes possible that these preconditions may not be met, the rating will be notched down following the general rule.

2.2.2 Difference in the Level of Public Support from Subsidiary Banks

The level of public support extended to banks and bank holding companies differs. The purpose of a public support is the protection of depositors and maintenance of orderly credit conditions, so there is no need to protect creditors of holding companies which do not engage in banking business. The possibility that the authorities will only bail out the subsidiary banks, or that they will restrict dividend payment from the subsidiary bank must be taken into consideration.

The Banking Law of Japan basically adopts the view that regulations for bank holding companies consistent with regulation for banks are necessary from the perspective of protection of soundness of bank management. Regulatory capital adequacy requirements are regulated at three levels: 1) banks as separate entities, 2) consolidated banks, and 3) consolidated holding company groups. In addition, authorities control holding companies and their subsidiary banks in a uniform manner, as witnessed by the issuance of business improvement orders to the holding companies. Thus, in ordinary circumstances, the authorities supervise the overall group by taking advantage of the holding company functions.

However, they may bail out only the subsidiary bank in the event of a failure. If measures under Item 1 of Article 102, Paragraph 1 of the Deposit Insurance Law (strengthening the equity capital) are applicable, capital reinforcement may be carried out through the holding company. Therefore, under ordinary circumstances, the rehabilitation process is likely to take advantage of the holding company functions, also from the perspective of public fund collection. However, in measures under Item 2 (protection of debt through special financial support) applicable to failed financial institutions, and measures under Item 3 (substantive nationalization of the bank under special crisis management), the debt of the holding company will not be protected. For example, in measures under Item 3, the Deposit Insurance Corporation of Japan will forcibly acquire shares of

the bank under special crisis management pursuant to Article 112. At the same time, the holding company will cease to be a bank holding company under the Banking Law, so it will no longer be supervised by the authorities. In the example of Ashikaga Bank, to which the measures under Item 3 was applied in 2003, the Deposit Insurance Corporation of Japan forcibly acquired all of its shares at zero yen on November 29. Entire debt of the subsidiary bank, including subordinated debts, was protected; however, the holding company Ashigin Financial Group filed for corporate rehabilitation proceedings.

Although the regulatory authorities supervise the holding company group in a uniform manner under ordinary circumstances, they will only protect the creditors of the subsidiary banks and not the creditors of the holding companies in the event of inevitable insolvency. Therefore, the floor Issuer Rating “BBB-” applied to banks that are likely to fall under Article 102 of the Deposit Insurance Law is not applicable to the holding companies. Based on the above, if the rating of a subsidiary bank in a bank holding company group is in the BBB zone with the main reason being public support, it is necessary to notch down the holding company regardless of double leverage status. When the application of measures under Item 3 becomes imminent, the difference in notches may be very significant.

A summary of these approaches are indicated below:

Basic approach to ratings of bank holding companies

(1)	As a rule, R&I will notch down a bank 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.

2.3 Securities Firm/Insurance Holding Companies

Holding companies of securities firms and insurance companies are also subject to supervision by the regulatory authorities, and inspection manuals have been established. Regulatory capital adequacy ratio for securities firms and solvency margin ratio for insurance companies are established on unconsolidated basis for the securities firms and insurance companies, and they are not regulated on consolidated holding company basis like the banks. There are no systematic public capital injections for the purpose of maintaining orderly credit conditions similar to the banks, and public support cannot be expected. Particularly for securities firms, customers' assets will be protected if they are properly segregated, so the supervision focuses on compliance with laws and regulations and securing fairness of transactions. Therefore, it is unlikely that only the subsidiary will be protected like the banks. If double leverage exists, the

general rule should be to notch down ratings similar to banks; however, due to the difference in extension of public support, a drastic difference between the Issuer Rating of the subsidiary and the holding company is unlikely. If the double leverage ratio is less than 100% and is unlikely to expand, the rating will be the same as the core subsidiary.

Insurance holding companies have more issues that need to be considered. The Insurance Business Law states that insurance policy obligations have priority, so the obligations of an insurance holding company are clearly subordinate to the insurance policy obligations of a life insurance company. Therefore, regardless of double leverage status, the Issuer Rating for the holding company will be notched down from the Group Creditworthiness. If double leverage exists, there will be further notching down.

3. Ratings of Affiliated Companies

3.1 Different Approaches Based on Positioning within the Group

For Issuer Rating of affiliated corporations, after evaluating the cohesiveness of each affiliated corporation with the group, one of the following approaches will be adopted: 1) a rating consistent with Group Creditworthiness; 2) a top-down approach, notching the rating down from the Group Creditworthiness; or 3) a bottom-up approach, taking into consideration the support of the group in the stand-alone creditworthiness of the affiliated corporation. Under normal circumstances, the rating of an affiliated corporation will not exceed the Group Creditworthiness; however, as an exception, the rating of a corporation that is unaffected by group risk, which has a unique business base, may be higher than the Group Creditworthiness.

Even where the entire group shares management resources, whether or not a funding support and/or capital support may be received from another corporation within the group if a subsidiary corporation faces financial distress will depend on the significance of such corporation within the group. In addition, an important member of the group may be required to support another corporation that face financial difficulties.

The positioning of affiliated corporations within the group is broadly categorized as follows: 1) core corporations; 2) corporations of equal importance as core corporations; 3) significant units in the group; 4) corporations with strategic significance; and 5) corporations with minor strategic significance. However, these categories are not static, and the strategic importance changes according to the environment. The behavioral pattern of Japanese financial groups seems to be getting increasingly dynamic, and in reflecting this on the ratings, the continuity of the positioning of each corporation must be thoroughly reviewed.

3.2 Core Corporations to have Equal Rating as Group Creditworthiness

A core corporation refers to a corporation that engages in the core business of the group, and is the basis of the existence of the group. Likelihood of its sale is low for the long term. It shares the brand and customer base with the group, and is an indispensable factor for the business operation of the group. In addition, it is important that such corporation does not have factors that may

harm the group cohesiveness such as larger business risk or financial risk compared to other corporations in the group. Even where a corporation is externally manifested as a core corporation, whether or not it is a true core corporation must be determined on a substantive basis.

Under normal circumstances, the rating of core corporations is consistent with the Group Creditworthiness. However, where there are multiple core corporations, and each corporation has relatively high independence, or large difference exists with respect to their contribution to the consolidated results, there may be one notch difference in their ratings.

3.3 Top-Down Approach Applied to Corporations of Equal Importance as Core Corporations

For corporations that can be deemed to possess equal importance as the core business, such as a business newly added to the core business through a merger that is receiving large management resources, a top-down approach starting from the Group Creditworthiness will be adopted. Taking into consideration the individual business risk and indispensability, the rating shall be consistent with the Group Creditworthiness, or 1 or 2 notches down depending on the level of risk involved. Where a top-down approach is adopted, in addition to the capital relationship, emphasis will be on the importance of its “function” within the group, and whether or not it is indispensable.

A case where an important business that should naturally be part of the core corporation is being operated by a separate corporation due to regulatory restrictions or other reasons, or a corporation that provides an infrastructure that is important to the entire group, may be deemed as a substantively important unit of the group, and a top-down approach will also be applied to these corporations. R&I rates the majority of wholly-owned life insurance subsidiary of a non-life insurance company the same as its parent. Although there are differences in risk characteristics and insurance period, the businesses themselves are highly similar. The firewall is also low for mutual entry into the life and non-life business, as witnessed by the use of existing agency network of the parent company. There are areas that can be handled by both of life and non-life insurance companies, such as medical and nursing care insurance. With the rapid liberalization of the non-life insurance presenting a threat to profits, life insurance business is very important, as high profitability can be expected. Its contribution to the consolidated earnings is small for now; however, as it can be deemed as part of the main business, the same rating is assigned.

3.4 Medium-Term Profit Outlook Also Used for Evaluation of Strategic Significance

For corporations other than the core corporations, corporations with equal importance as core corporations, and corporations that are deemed to be an important business unit, a bottom-up approach based on the stand-alone evaluation with notching up corresponding to the importance to the entire group will be adopted. In a bottom-up approach, 1) tangible and intangible advantages such as utilization of group management resources, and 2) the possibility of support from other members of the group in case of financial distress, will be added to the stand-alone credit evaluation results. For 1) above, redundancy must be avoided, as a long-standing member of

a group should be reflected in the existing financial statements.

For determination of the strategic significance, the necessity to the core business of the group, the positioning of such corporation in the long-term strategy of the group, and the ratio of contribution to consolidated profits will be essential. In addition, to be strategically significant, a corporation must be expected to produce appropriate return in relation to its risk in the medium term.

3.5 Corporations Isolated from Risks may have Higher Rating than Group Creditworthiness

The rating of a corporation that is isolated from group risks may be higher than the Group Creditworthiness. A trust bank specializing in asset management business may fall under this category. Points considered for determination of isolation from risks are the following:

- 1) Isolation of the corporation will be enhanced if shareholders other than the parent company exist, and an agreement to maintain creditworthiness of such corporation such as maintenance of net assets has been executed by the shareholders.
- 2) Maintenance of high creditworthiness for such corporation aligns with the group interest.
- 3) Due to the characteristics of the business, such corporation is unlikely to support another group corporation.
- (4) It can exist apart from the group.

Even if these points are formally met, the group may have substantively significant control; therefore, “risk isolation” must be determined on a substantive basis. If only a part of the above is met, the degree of risk isolation shall be reviewed carefully. Furthermore, even if a corporation is isolated from risks, it must have smaller business risk and financial risk compared to the level of such risks for the rest of the group in order to receive a higher rating than the Group Creditworthiness. Where a corporation that is isolated from the group risk exists, evaluation of the Group Creditworthiness must exclude such corporation.

3.6 Conditions of Investors Scrutinized for Joint Ventures

For joint ventures involving multiple investors, the status of participation of investors is important. Even if an investor does not hold majority of the voting rights, if the joint venture is strategically significant to such investor and it is deeply involved in the management of the joint venture, the creditworthiness of such investor may be reflected correspondingly.

The methodologies and models R&I uses in connection with evaluation of creditworthiness (collectively, the “Rating Methodologies”) are statements of R&I’s opinions prepared based on R&I’s own analysis and research, and R&I makes no representation or warranty, express or implied, as to the accuracy, timeliness, adequacy, completeness, merchantability, fitness for any particular purpose, or any other matter with respect to the Rating Methodologies. Further, disclosure of the Rating Methodologies by R&I does not constitute any form of advice regarding investment decisions or financial matters or comment on the suitability of any investment for any party. R&I is not liable in any way for any damage arising in respect of a user or other third party in relation to the content or the use of the Rating Methodologies, regardless of the reason for the claim, and irrespective of negligence or fault of R&I. All rights and interests (including patent rights, copyrights, other intellectual property rights, and know-how) regarding the Rating Methodologies belong to R&I. Use of the Rating Methodologies, in whole or in part, for purposes beyond personal use (including reproducing, amending, sending, distributing, transferring, lending, translating, or adapting the information), and storing the Rating Methodologies for subsequent use, is prohibited without R&I’s prior written permission.

Japanese is the official language of this material and if there are any inconsistencies or discrepancies between the information written in Japanese and the information written in languages other than Japanese the information written in Japanese will take precedence.