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Revisions of Rating Methodology by Sector “Securities”

Japan Credit Rating Agency, Ltd. (JCR) hereby announces that it has revised its Rating Methodology by sector “Securities.”

JCR revised the Rating Methodology as a result of considerations that were announced in its press release "JCR Solicits Public Comments on Revisions to Rating Methodology by Sector ‘Securities’" dated February 7, 2025, and JCR decided the Rating Methodology as proposed at the time of requesting the public comments on them. There are no individual ratings that need to be revised as a result of these revisions.

The revised rating methodology will be posted on the page of “Rating Methodologies: Financial Institutions” (https://www.jcr.co.jp/en/rrinfo/meth_finance/).

Kengo Sakaguchi, Akira Minamisawa, and Naoki Shimura

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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Rating Methodology by Sector

Securities

This rating methodology mainly applies to securities companies in Japan. JCR applies this rating methodology with the necessary adjustments such as those to the indicators for analysis for overseas securities companies, based on the laws, accounting systems, regulations, and financial administrations in which those entities are located.

1. Business base

(1) Industry Characteristics

(i) Market size and growth potential

Securities companies' business is diverse, and includes brokerage services such as buying and selling stocks and bonds for clients, investment banking services such as M&A advisory, fundraising support, and IPO underwriting, and asset management services such as management and administration of client assets.

In the case of brokerage and investment banking services, earnings fluctuate greatly depending on the economic environment and conditions in financial markets, etc. In contrast, earnings from asset management services are relatively stable. Looking at the securities industry as a whole, while the balance of assets under management is on an upward trend, the earnings scale has not shown growth over the long-term due to decline in commission rates accompanying intensifying competition. However, rates for stock and investment trust trading commissions, trust fees, etc. have already reached a fairly low level, and there is little room for further reductions. The government is encouraging individuals to grow their assets through NISA and iDeCo. When judging market growth potential, JCR also looks at the trend of "from savings to investment."

(ii) Competition

Main securities companies are broadly divided into the following categories according to their business areas: large securities companies, semi-large securities companies, and online securities companies. Large securities companies operate globally and have strengths in their large customer bases, which are backed by the large balance of assets under management in both retail and wholesale businesses, with face-to-face sales as the mainstay. Semi-large securities companies operate mainly in the domestic retail sector with face-to-face sales as the mainstay, and have strengths in their unique business foundations rooted in the local community. Online securities companies are popular for their low commission rates and simple transaction procedures via Internet, and they have a strong presence in retail sector, particularly in stock trading and margin transactions.

Securities industry is a registered system, and there are relatively high barriers to entry. However, with pervasion of asset formation support systems such as NISA and iDeCo, spread of online services, and lower commission rates and commission–free trading, competition among securities companies is intensifying, particularly in the retail sector. While online securities companies are working to increase the number of customers and trading volume by offering commission-free stock and investment trust trading, large and semi-large securities companies are strengthening their business for high net worth and semi-high net worth individuals by focusing on face-to-face consulting. In wholesale sector, presence of large securities companies is high, with the entry of semi-large securities and online securities companies being limited. However, this is also a sector that foreign securities companies are actively promoting, and competition can be seen among certain players.

In addition, as business environment surrounding the securities industry undergoes major changes, there is a growing trend towards alliances as a means of increasing competitiveness. In addition to the strengthening of integration of banking and securities services within megabank groups, there is a trend towards strengthening the alliances between large securities companies and online securities companies, and they each are working to expand their business bases in the retail sector, with large securities companies utilizing the non-face-to-face channels of online securities companies, and online securities companies utilizing the face-to-face channels of large securities companies. Furthermore, there are also alliances being formed across industry boundaries, such as between online securities companies and mobile phone carriers.

(iii) Transaction stability

Stability of transactions at large and semi-large securities companies is relatively high. In the retail sector, there are many high net worth and semi-high net worth individuals who want long-term and stable relationships through face-to-face consultations on asset management. In the wholesale sector, customers often select a specific securities company as the lead manager on a continuous basis for bond and stock issuance. On the other hand, stability of trading at online securities companies is somewhat low. Since switching costs are not high, customers are likely to switch to other companies in the same industry depending on trends in commission rates and other factors. In addition, there are many customers who use multiple securities companies depending on the products or services.

(iv) Protection and regulation

Securities companies are subject to supervision by Financial Services Agency, and are required to calculate their capital adequacy ratio, which indicates whether they have sufficient capital to cover risks, and to maintain a ratio above a certain level. If the capital adequacy ratio falls below 120%, the company is subject to measures such as changes to its business methods, and if it falls below 100%, it is subject to measures such as suspension of business. The stock exchange also has rules for measures based on capital adequacy ratio. Some large securities companies are subject to Basel Standards.

From the perspective of protecting customers in the event of bankruptcy, the Financial Instruments and Exchange Act requires securities companies to manage customer assets separately from their own assets and other invested assets. In addition, under the Deposit Insurance Act's resolution regime, they are subject to "Measures for Orderly Resolution of Assets and Liabilities of Financial Institutions for Ensuring Financial

System Stability.”

(2) Market Position and Competitiveness

When evaluating the market position of securities companies, JCR places importance on the customer base. The customer base is an important factor that will secure future earnings, and it is a support for whether or not earnings can be secured to cover expenses during times of sluggish market. For the customer base, JCR uses indicators such as the number of accounts, balance of assets under management, trend in stock trading value, and the results of various league tables for stocks, bonds, and M&A in chronological order, and JCR confirms the status of transactions with issuers and investors in Japan and overseas, as well as the degree of deepening of those relationships. As these indicators are affected by market conditions, JCR focuses on medium- to long-term trends and changes in market share, rather than temporary fluctuations, and checks movements of individual companies compared to overall industry trends and whether there are any structural changes.

JCR looks at not only a simple increase or decrease in the number of accounts or assets under management, but also at the activity status of the accounts, status of attracting high net worth individuals and customers who trade frequently, changes in the product mix of assets under management, and status of net asset inflow. In addition, JCR also checks trends in share of stock trading value, and if there are significant changes in the share, JCR analyzes the factors behind this and the impact on the profits (losses) of individual companies. JCR places importance on various league tables and the number of lead managers when evaluating the customer base in the wholesale sector. JCR pays attention not only to temporary performance, but also to whether or not the company is able to secure ongoing and multifaceted transactions with their main customers.

In terms of competitiveness, it is important whether the company can provide products and services with higher added value, responding to the diversifying needs of customers. There is not much difference between the products handled by securities companies, so it is difficult to establish a competitive advantage in terms of products. In differentiating the company from other companies, advanced know-how, securing of capable human resources, and appropriate personnel allocation are necessary. Large and semi-large securities companies are strengthening their wealth management businesses, which comprehensively manage the assets held by customers. JCR confirms whether sufficient resources can be allocated to face-to-face services centered on asset management consulting. On the other hand, online securities companies tend to be prone to price competition. JCR focuses on superiority or inferiority compared to other companies concerning commission rates, product lineups, convenience of tools and UIs, as well as status of inducing customers to buy products using economic sphere such as groups and alliances, and degree of diversification of businesses such as margin transactions, US stocks, and FX.

(3) Management Strategy and Governance

Management strategy and governance are factors that affect the direction of business base and also their financial base. With regard to management strategy, JCR evaluates whether the company is able to formulate and execute a management strategy by accurately understanding the impact of factors such as economic and financial conditions, market trends, as well as changes in competitive environment and regulations. JCR also pays attention to the direction of risk appetite. Starting new businesses or making acquisitions can be effective growth and differentiation strategies, but there is also a possibility that they will not produce the expected results and will put pressure on profits and finances. Taking these possibilities into account, JCR checks whether the risk taking is appropriate in light of the scales of business and capital of the individual companies.

As a direct finance provider, the importance of governance is particularly high in the securities industry. JCR checks whether the company has appropriate systems in place for corporate governance, such as a board of directors, and for business administration, and whether it has appropriate risk management and compliance systems in place and is operating them properly. Since securities companies handle much insider information, they are prone to scandals, such as violating laws that regulate insider trading. If a scandal or other incident occurs, it could have a negative impact on the company's performance, such as through suspension of business or exclusion from lead manager of underwriting operations, and it could also damage the company's customer base through a decline in its reputation. JCR checks whether the company has established a system to prevent scandals from occurring, and whether it can make progress in establishing a system to prevent similar incidents from occurring in the future when scandals occurred.

2. Financial base

(1) Earnings Power

Securities companies are characterized by the fact that their earnings and values of their assets and liabilities are generally more likely to fluctuate due to changes in the economic environment and other factors. When rating securities companies, it is more important than in other industries to analyze factors causing changes in detail, rather than focusing on temporary level of profits and finances, and JCR makes its decisions on the assumption that this is an industry with high earnings volatility as a business characteristic. In assessing earnings power, JCR places importance on ordinary income, net operating revenue, and earnings/ RWA ratio, and focuses on their medium- to long-term levels and their stability. While it is difficult to evaluate performance against plans due to the high volatility of earnings caused by market conditions, it is useful to compare performance across companies, and when JCR sees movements that differ from other companies, JCR analyzes the factors behind this and considers the impact on future earnings and finances.

Diversification of customer base and revenue sources is important for gauging future earnings power and revenue stability, and JCR focuses on whether revenue sources have well diversified from the perspectives of segments, products, regions, customer segments, etc. based on the composition of net operating revenue. In addition, it is important to minimize a decline in profits during periods of market slump, so JCR checks the weight of stable revenue such as trust fees and fund wrap related fees and how much fixed costs are covered by this revenue. With regard to expenses, it is important to keep the break-even point at a low point by conducting business with an awareness of turning fixed costs into variable costs, and JCR pays particular attention to the trends in personnel and system costs.

Key financial indicators:

- Net operating revenue and its composition
- Ordinary income
- Earnings/ RWA ratio (ordinary income/ risk-weighted assets)
- Fixed cost coverage ratio (stable revenue/ fixed expenses)
- SG&A expenses and their composition
- SG&A ratio (SG&A expenses/ net operating revenue)

(2) Asset Quality & Risk Management System

Securities companies may suffer significant losses due to changes in external environment in businesses that use their own balance sheets. Trading and underwriting operations are mainly transactions based on customer flows, but there are cases where positions temporarily expand or inventories remain for long periods of time. On the other hand, in proprietary trading and financing operations, there are cases where assets with high price fluctuation risk or low liquidity are held. Therefore, JCR focuses on whether a system is in place to respond appropriately to sudden changes or unexpected movements in the market, and whether quick and flexible management decisions can be made. In the wholesale sector, products and transactions are becoming increasingly complex due to diversification of customer needs, and it is expected that they will take excessive risks in the pursuit of profits in the midst of market cycles. In particular, in overseas business, more careful management is required due partly to the fact that large securities companies have suffered large losses in the past. In the retail sector, risks are relatively low, and although losses may occur in margin transactions, forwards, futures and options trading, etc., a possibility of large losses is low.

From a quantitative perspective, JCR checks the company's policies on acquiring and holding assets, trend in balance of assets, trends in various risk amounts, and the balances with capital. Regarding risk amounts, JCR focuses on average values, maximum and minimum amounts, etc. over a certain period of time, rather than these figures on a single point in time. In integrated risk management, risk amount recognized differs depending on the methods and assumptions (e.g., holding period, confidence level, observation period, etc. for VaR), so simple comparisons among companies are difficult. JCR makes an evaluation, focusing mainly on how management perceives its own risk-taking situation and how this can be linked to formulation of management plans and capital policies. In terms of operations, key point is whether there is an effectively working system of checks in place among organizations and staff members. Even if risk management is excellent, it is unlikely to be a positive factor for evaluation of creditworthiness, while if risk management is seen as being lax, it can be a negative factor.

(3) Capital Adequacy

Capital adequacy affects capabilities of securities companies to carry out trading, proprietary trading, underwriting and other operations, and has an impact on competitiveness. In situations where a periodic income has long been in the red, size of capital is the last resort, so the thickness of capital is important. JCR looks at whether the company maintains a sufficient capital level in relation to risks, and also refers to the risks, on which a certain amount of stress is placed under a stress test. JCR also checks whether the company is able to respond flexibly and appropriately while keeping an eye on changes in capital regulations and other developments.

In assessing capital adequacy, JCR focuses on levels of shareholders' equity and owners' equity, regulatory capital adequacy ratio, and adjusted leverage ratio. In terms of regulatory capital adequacy ratio, for large securities companies subject to Basel Standards, JCR places importance on total capital ratio, Tier 1 capital ratio, and common equity Tier 1 capital ratio, and focuses more on indicators with higher equity content. When evaluating, JCR takes full implementation of Basel III into account. On the other hand, for other securities companies, JCR focuses on capital adequacy ratio.

In general, securities companies have large fluctuations in their positions and risk amounts, so JCR does not judge their adequacy of capital or soundness of their finances based on their capital adequacy ratio or adjusted leverage ratio at a single point in time. If there are significant changes in these ratios, it is important to consider whether factors behind those changes are temporary or part of a medium- to long-term trend.

Key financial indicators:

- Shareholders' equity, owners' equity
- Total capital ratio
- Tier 1 capital ratio
- Common equity Tier 1 capital ratio
- Capital adequacy ratio
- Adjusted leverage ratio ((total assets less assets related to transactions with repurchase/resale agreements and repo transactions)/ net assets)

(4) Liquidity

JCR focuses on whether securities companies can raise stable and low-cost funds in order to respond flexibly to expansion of trading assets and margin transactions. JCR checks stability of short-term financing, medium- to long-term fundraising policies, balance between long- and short-term financing, debt repayment and redemption schedules and preparations for them, status of diversification of financing sources, securing of assets to secure a switch to secured debt financing, and relationships with financial institutions through a line of credit and other means. In addition, JCR checks the company's plans for contingencies such as a sudden market fluctuation, status of liquidity on hand and highly liquid assets to cover short-term financing, and implementation status of stress tests and monitoring.

Large securities companies that operate globally are strongly required to manage liquidity across the entire group and to improve the management system, and to secure financing sources in major financial markets. In addition, JCR also pay attention to whether they cover low-liquidity assets by capital and long-term loans, and whether they conduct appropriate fund management among group companies.

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