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Revisions to Rating Methodologies for "Credit Sales and Credit Cards" and "Consumer Finance"

Japan Credit Rating Agency, Ltd. (JCR) hereby announces that it has revised its Rating Methodologies by sector "Credit Sales and Credit Cards" and "Consumer Finance." JCR revised the Rating Methodologies as a result of considerations that were announced in its press lease "JCR Solicits Public Comments on Revisions to Rating Methodologies for 'Credit Sales and Credit Cards' and 'Consumer Finance'" dated May 23, 2022, and JCR decided the Rating Methodologies as proposed at the time of requesting the public comments on them.

In accordance with the revisions, JCR will promptly review the long-term issuer ratings of Orient Corporation and JACCS CO., LTD. JCR believes that the change in the ratings, if any, as a result of the review, will be one notch.

In the request for the public comments, there was a request to enhance the description in the report regarding the level of indicators and their changes with respect to indicators for evaluation of capital adequacy such as capital margin relative to risk. JCR will explain this point in individual issuer reports.

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Rating Methodology by Sector

Credit Sales and Credit Cards

The following applies to credit card companies and credit sales companies in Japan. JCR applies this rating methodology with the necessary changes in the indicators for analysis to overseas credit card companies and credit sales companies, based on laws, accounting system, financial administration in which these entities are located.

1. Business base

(1) Characteristics of Industry

Credit card companies and credit sales companies provide sales credit to consumers by advancing payment for goods and services. Credit card companies are mainly engaged in membership services such as member recruitment and card issuance, member store services such as participating member store recruitment and management, and outsourcing services such as card-related administrative services. The core business of credit sales companies is installment credit, which involves recruiting and managing member stores and advancing and collecting payments from consumers when they make installment payments to member stores.

(i) Market Size and Growth Potential

The credit card shopping market is large. Credit cards are widely used in a wide range of areas, from small to large payments, and are widely accepted by consumers. Card shopping also has a high medium- to long-term market growth rate. The shift from cash payments to cashless payments is continuing against a backdrop of high convenience and government promotion.

The installment credit market is smaller than the credit card shopping market. The installment sales are centered on high-value products for which installment payments are preferred. Although installment sales are more susceptible to economic fluctuations than card shopping, demand is firm, especially for mainstay auto and home remodeling.

(ii) Competitive situation

Competition in the credit card industry is fierce, as there are a large number of companies. Many customers already have multiple credit cards. In order to maintain and expand their membership base, credit card companies need to spend a large amount of money on expenses of sales promotion such as sign-up campaigns and point redemptions. Member stores often have contracts with multiple credit card companies, which can put downward pressure on merchant fee rates. In addition, as cashless payments become more prevalent, payments are becoming smaller in value and larger in quantity, and the burdens of system investment and fees charged to payment network providers are increasing, which is also leading to lower profitability. Apart from credit cards, there is also competition from payment methods such as e-money and QR code payments.

Competition in the installment credit industry is relatively fierce, as while the major players have a large share of the market, there are also many small- and medium-sized companies in the industry. Since member stores often have contracts with multiple credit sales companies, there is likely to be downward pressure on merchant fee rates.

(iii) Regulations

Credit card companies and credit sales companies are primarily affected by the Money Lending Business Act and the Installment Sales Act. From the perspective of consumer protection, it is necessary to be aware of the risk of stricter regulations.

With regard to the Money Lending Business Act, the Act was fully enforced in 2010, and restrictions on total lending limits the maximum amount of outstanding loans, and maximum interest rates were lowered. With regard to the Installment Sales Act, the revised Installment Sales Act went into effect in 2010, mandating a survey of estimated payable amounts. Subsequent revisions have mandated surveys of member stores, as well as appropriate management of credit card information and prevention of fraudulent use at member stores.

(2) Market Position and Competitiveness

The ability to establish a strong market position and competitiveness is extremely important in assessing creditworthiness, as it greatly influences future earnings power.

For credit card companies, JCR evaluates the market position and competitiveness of each business within the industry, including membership, member store, and outsourcing services. For membership services, JCR analyzes the strength of the membership base in terms of the number of members, member utilization rates and spending per transaction, and sales policies such as campaigns to acquire members and promote usage. In the area of member store services, the strength of the member store network will be evaluated by checking the number of member stores, status of large member stores and member stores by industry, and status of merchant fee rates. In the outsourcing services, JCR confirms whether the company is expanding its business by utilizing its own expertise cultivated through its membership and member store services. Based on the above, JCR will evaluate the size and growth potential of transaction volume and operating asset balance.

For credit sales companies, JCR will evaluate whether they have established strong relationships with member stores and are profitable by checking the number of member stores for installment sales, status of large member stores and member stores by industry, and status of merchant fee rates. As with credit card companies, JCR evaluates the size and growth potential of transaction volume and operating asset balance.

In addition to the market position and competitiveness of each business, diversity and stability of business portfolio as a whole are also important. In addition to credit cards, credit card companies are often involved in a variety of payment services such as prepaid cards, debit cards, and deferred payment settlement, as well as credit guarantees for personal loans. JCR confirms the fulfillment of these businesses. For credit sales companies, in addition to installment payments, JCR also looks at the extent of other businesses, such as credit cards and credit guarantees. Credit card companies and credit sales companies mainly target the domestic market, but from the perspective of diversification of revenue sources and growth potential, it is also important to consider how well they are expanding into overseas markets.

Credit card and credit sales companies are often part of banking and distribution groups. Companies in banking groups have access to customer bases such as bank accounts. Distribution group companies have access to the group's customer acquisition channels, as well as the group's common points and economic zones. The business trends of the parent company and group companies have a significant impact on the size and growth potential of the transaction volume and operating assets of the credit card companies and credit sales companies under their umbrella. Therefore, the utilization of management resources of the parent company and group companies should be strongly reflected in the assessment of their market position and competitiveness.

(3) Management Strategy and Governance

Management strategy and governance are factors that reduce or increase risks because they have a significant impact on the direction of the business foundation. With regard to management strategy, JCR evaluates whether the company is able to formulate and execute management strategies based on the business environment. JCR also focuses on whether the company pays attention to the balance between risk and return after confirming its risk-taking policy. Regarding governance, JCR checks status of the board of directors and other corporate governance systems, management control systems, and internal controls such as risk management and compliance.

2. Financial Base

(1) Earnings Strength

Credit card companies and credit sales companies are prone to inflated sales promotion expenses and system-related costs, which can put downward pressure on merchant fee rates. JCR will evaluate whether the company can absorb bad debt expenses and financing costs through profit before write-offs and allowances. In addition, to assess cost efficiency, JCR checks the expense ratio that is adjusted for bad debt expenses and interest repayment expenses from selling, general, and administrative expenses.

For profitability, JCR focuses on ROA. For the numerator, JCR uses ordinary income before and after deducting bad debt expenses. For the denominator, JCR uses total assets or operating assets. Adjustments are made to include off-balance-sheet receivables such as securitized receivables and off-balance-sheet guarantees.

It should be noted that there are differences in accounting standards among credit card companies and credit sales companies. With regard to revenue recognition standards, there are cases where fees are recognized based on the installment period, and cases where fees are recognized in a lump sum at the time of sale. In addition, note that there are cases where revenues are temporarily increased due to securitization of receivables.

In addition to quantitative perspectives, the focus should be on the revenue mix and the stability and diversity. The main revenue sources for credit card companies are merchant fees, annual membership fees from members, shopping revolving and installment payment fees, interest on loans, and administration fees for the outsourcing services. JCR focuses on whether merchant fees are profitable and whether profitable shopping revolving and installment fees and interest on loans are substantial. JCR also looks at the degree of diversification of revenue sources through other businesses such as administration fees for the outsourcing services and credit guarantee revenue. For credit sales companies, JCR also looks at whether they are profitable in terms of installment sales and whether they have diversified revenue sources from other businesses such as credit card revenues, loan revenues, and credit guarantee revenues.

Key financial indicators:

- Ordinary income and Ordinary income before write-offs and allowances
- Expense ratio
- ROA

(2) Asset Quality

Deterioration of asset quality directly leads to an increase in bad debt expenses, which in turn leads to a deterioration in business performance. In order to look at past performance regarding whether asset quality is under control, JCR checks the trend of bad debt expenses in relation to operating assets. To determine future trends in asset quality, JCR confirms the status of factors such as delinquent receivables, which is a leading indicator. JCR looks at the occurrence of delinquencies, status of bad debt write-offs, and whether allowance is conservative.

On the qualitative side, credit management system is important. JCR looks at initial credit, credit in process, and the stance and methods of debt collection, and confirms that they are being properly managed. Operating assets consist mainly of small and diversified personal loans. Credit card companies and credit sales companies make credit decisions by constructing scoring models based on the law of large numbers. In general, credit card monthly clear (one-time payment) receivables and installment credits are credits based on the purchase of goods and have a smaller bad debt risk, while cash advances tend to have a higher bad debt risk because they are sometimes used to pay off other debts. The risk profile of operating assets is determined by looking at customer attributes, product lineup, and risk-taking policies.

In addition to credit risk, JCR also checks the status of interest repayment risk, member store risk, and other risks. With regard to interest repayment risk, in addition to the number of disclosure claims as a leading indicator, the number and amount of repayments and the sufficiency of allowance for loss are evaluated. Regarding member store risk, if the member store has a defect, chargebacks due to cancellation or termination of contract may be incurred. After understanding the series of member store management operations, JCR confirms that no problems have occurred.

Key financial indicators:

- Bad debt expenses relative to operating assets
- Delinquent receivables ratio, write-off ratio, and allowance ratio
- Interest repayment, allowance for loss on excess interest repayment

(3) Capital Adequacy

Capital adequacy is important as a final buffer against visible risks. In making the assessment, JCR focuses on equity ratio. For the numerator, deferred installment income, goodwill, deferred tax assets, and equity securities are adjusted against equity capital. For the denominator, operating assets and off-balance sheet receivables, such as securitized receivables and off-balance sheet guarantees, are adjusted to reflect their risk weight according to their risk profile, and are included in total assets.

JCR also places emphasis on capital margin relative to risk. JCR evaluates the extent to which risks such as credit risk and market risk based on stress scenarios can be covered by capital, future profits, and other factors.

On the qualitative side, JCR will also focus on risk management systems, such as how the company recognizes the risks it faces and whether it has sufficient capital based on balance between risk and return, and whether it manages these risks appropriately.

Key financial indicators:

- Equity ratio
- Capital margin relative to risk

(4) Liquidity

For non-banks such as credit card companies and credit sales companies, financing, as purchases, has a significant impact on business continuity. If financing capacity becomes scarce due to deterioration in the business environment or business performance, it will become a constraining factor in expanding operating assets. JCR checks the financing structure and looks at the stability of financing and the status of financing costs.

Specifically, JCR looks at liquidity on hand, composition of financial institutions with which the company does business, status of transactions with each financial institution (amount and terms of borrowings, overdrafts, commitment lines, etc.), status of collateral, concept of covenants, status of fund management by the parent company and group companies, diversity of financing means (CP, bonds, securitization of receivables, etc.), financing mix (balances between long-term and short-term financing, indirect and direct financing, and fixed-rate and floating-rate financing), and diversification of debt maturities (Are large debt repayments concentrated at specific times?).

Cash management is also important for credit card companies and credit sales companies because they collect payments from members and customers and make advance payments to member stores on behalf of members and customers, on specific days each month, and the amounts involved are significant. In addition to the cash management policy during normal times, JCR also confirms contingency plans.

Key financial indicators:

- Liquidity on hand
- Direct financing ratio, short-term financing ratio

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Rating Methodology by Sector

Consumer Finance

The following applies to consumer finance companies that provide unsecured loans to individuals in Japan and does not apply to credit card companies and credit sales companies. JCR applies this rating methodology with the necessary changes in the indicators for analysis to overseas consumer finance companies, based on laws, accounting system, financial administration in which these entities are located.

1. Business base

(1) Characteristics of Industry

Consumer finance companies provide unsecured loans to individuals. They are also engaged in other businesses such as credit guarantee and debt collection, utilizing the know-how cultivated through unsecured loans.

(i) Market Size and Growth Potential

The size of the consumer finance market has shrunk compared to the past, largely due to the 2006 Supreme Court ruling and the enforcement of the Money Lending Business Act. In addition, consumer finance has somewhat low market growth potential over the medium to long term. Restrictions on total lending are a constraint, and significant growth is unlikely. From a long-term perspective, it should be also noted that the number of young people, the main customer segment, will decline due to the falling birthrate and aging population.

(ii) Competitive Situation

Competition in the consumer finance industry is relatively fierce. Following the market contraction following the enforcement of the Money Lending Business Act, the number of registered moneylenders has significantly declined, resulting in an increase in the market share of major players. However, due to maximum interest rates, there is no significant difference in lending rates among consumer finance companies, making it difficult to differentiate their products. Unsecured loans from consumer finance companies also compete with bank card loans and credit card cash advances and shopping revolving. In addition, there have been moves by companies from other industries to enter the market for unsecured loans to individuals.

(iii) Regulations

Consumer finance companies are primarily affected by the Money Lending Business Act. From the perspective of consumer protection, it is necessary to be aware of the risk of stricter regulations.

Maximum interest rates for consumer finance companies have been regulated by the Interest Rate Restriction Act and the Investment Act. The maximum interest rate under the Interest Rate Restriction Act has been 15%-20% since its enactment in 1954. On the other hand, the maximum interest rate under the Investment Act was 109.5%

when it was first enacted in 1954, but has been gradually lowered based on social conditions at the time.

The Money Lending Business Act was enforced in stages from 2006 to 2010, and after 2010, interest rate regulations were imposed to reduce the maximum interest rate under the Investment Act from 29.2% to 20%, and loans with gray zone interest rates, the interest rate range between the Investment Act and the Interest Rate Restriction Act, were prohibited. Regulations on total lending, which in principle prohibit loans whose total outstanding balance exceeds one-third of annual income, were also imposed. In addition, since the Supreme Court ruled in 2006 that the deemed repayment provision was effectively invalid, there has been a sharp increase in claims for interest repayment.

(2) Market Position and Competitiveness

The ability to establish a strong market position and competitiveness is extremely important in assessing creditworthiness, as it greatly influences future earnings power.

For consumer finance companies, JCR evaluates their market position and competitiveness mainly in the area of unsecured loans. The ability to secure new and existing customers in number and maintain and expand operating assets is important. In attracting new customers, it will be difficult to differentiate by loan rates, but competitive advantages will include those in brand power, sales channels, and screening systems. In terms of brand power, they need to effectively advertise on TV, Internet, and other media to raise their visibility and enhance their corporate image so that they will be an option for customers when they need funds. In the past, the main sales channels were in-store counters, automatic contract machines, and company ATMs, but in recent years the focus has shifted to non-in-store channels such as Internet, telephone, and affiliated ATMs, making it important to improve convenience. In terms of screening, customers often apply to multiple consumer finance companies at the same time when they borrow, and a company with the quickest response is more likely to be selected, so efficient screening is required. Based on these circumstances, JCR will evaluate the size and growth potential of operating asset balance.

In addition to the market position and competitiveness of each business, diversity and stability of business portfolio as a whole are also important. Consumer finance companies are often involved in credit guarantees for personal loans and debt collection based on the expertise they have accumulated in unsecured loans, and JCR will check the fulfillment of these businesses. For credit guarantees, JCR looks at the status of relationships with partner financial institutions, product lineup, and guarantee balances. In addition, consumer finance companies mainly target the domestic market, but from the perspective of revenue source diversification and growth potential, it is also important to consider how well they are expanding into overseas markets.

Consumer finance companies may belong to certain groups, such as banks. Companies in banking groups have access to customer bases such as bank accounts and are responsible for providing credit guarantees for personal loans made by the parent bank and group companies. The business trends of the parent company and group companies have a significant impact on the size and growth potential of balances of operating assets and guarantees of the consumer finance companies under their umbrella. Therefore, the utilization of management resources of the parent company and group companies should be strongly reflected in the assessment of their market position and competitiveness.

(3) Management Strategy and Governance

Management strategy and governance are factors that reduce or increase risks because they have a significant impact on the direction of the business foundation. With regard to management strategy, JCR will evaluate whether the company is able to formulate and execute management strategies based on the business environment. JCR also focus on whether the company pays attention to the balance between risk and return after confirming its risk-taking policy. Regarding governance, JCR checks status of the board of directors and other corporate governance systems, management control systems, and internal controls such as risk management and compliance.

2. Financial base

(1) Earnings Strength

Compared to other industries, consumer finance companies aggressively take risk, which inevitably incur a certain amount of bad debt expenses. JCR will evaluate whether the company can absorb bad debt expenses and financing costs through profit before write-offs and allowances. In addition, to assess cost efficiency, JCR checks the expense ratio that is adjusted for bad debt expenses and interest repayment expenses from selling, general, and administrative expenses.

For profitability, JCR focus on ROA. For the numerator, JCR uses operating revenue or ordinary income before and after deducting bad debt expenses. For the denominator, JCR uses total assets or operating assets. Adjustments are made to include off-balance-sheet receivables such as securitized receivables and off-balance-sheet guarantees.

In addition to quantitative perspectives, the focus should be on the revenue mix and the stability and diversity. The main revenue source for consumer finance companies is interest on unsecured loans, but JCR also confirms that revenue sources from other businesses such as credit guarantee revenue are diversified.

Key financial indicators:

- Ordinary income and Ordinary income before write-offs and allowances
- Expense ratio
- ROA

(2) Asset Quality

Deterioration of asset quality directly leads to an increase in bad debt expenses, which in turn leads to a deterioration in business performance. In order to look at past performance regarding whether asset quality is under control, JCR checks the trend of bad debt expenses in relation to operating assets. To determine future trends in asset quality, JCR confirms the status of delinquent receivables, which is a leading indicator. JCR looks at the occurrence of delinquencies, status of bad debt write-offs, and whether allowance is conservative.

On the qualitative side, credit management system is important. JCR looks at initial credit, credit in process, and the stance and methods of debt collection, and confirms that they are being properly managed. Operating assets consist mainly of small and diversified personal loans. Consumer finance companies make credit decisions by constructing scoring models based on the law of large numbers. In general, consumer finance companies lend unsecured loans to customer segments with relatively low incomes, which tends to increase the bad debt risk. The risk profile of operating assets is determined by looking at customer attributes, product lineup, and risk-taking policies.

In addition to credit risk, JCR also checks the status of interest repayment risk and other risks. With regard to interest repayment risk, in addition to the number of disclosure claims as a leading indicator, the number and amount of repayments and the sufficiency of allowance for loss are evaluated.

Key financial indicators:

- Bad debt expenses relative to operating assets
- Delinquent receivables ratio, write-off ratio, and allowance ratio
- Interest repayment, allowance for loss on excess interest repayment

(3) Capital Adequacy

Capital adequacy is important as a final buffer against visible risks. In making the assessment, JCR focuses on equity ratio. For the numerator, goodwill, deferred tax assets, and equity securities are adjusted against equity capital. For the denominator, operating assets and off-balance sheet receivables, such as securitized receivables and off-balance sheet guarantees, are adjusted to reflect their risk weight according to their risk profile, and are included in total assets.

JCR also places emphasis on capital margin relative to risk. JCR evaluates the extent to which risks such as credit risk, market risk and interest repayment risk based on stress scenarios can be covered by capital, future profits, and other factors.

On the qualitative side, JCR will also focus on risk management systems, such as how the company recognizes the risks it faces and whether it has sufficient capital based on balance between risk and return, and whether it manages these risks appropriately.

Key financial indicators:

- Equity ratio
- Capital margin relative to risk

(4) Liquidity

For non-banks such as consumer finance companies, financing, as purchases, has a significant impact on business continuity. If financing capacity becomes scarce due to deterioration in the business environment or business performance, it will become a constraining factor in expanding operating assets. JCR checks the financing structure and looks at the stability of financing and the status of financing costs.

Specifically, JCR looks at liquidity on hand, composition of financial institutions with which the company does business, status of transactions with each financial institution (amount and terms of borrowings, overdrafts, commitment lines, etc.), status of collateral, concept of covenants, status of fund management by the parent company and group companies, diversity of financing means (CP, bonds, securitization of receivables, etc.), financing mix (balances between long-term and short-term financing, indirect and direct financing, and fixed-rate and floating-rate financing), and diversification of debt maturities (Are large debt repayments concentrated at specific times?).

Cash management is also important for consumer finance companies because they collect payments from customers on a specific day each month, and the amounts involved are significant. In addition to the cash management policy during normal times, JCR also confirms contingency plans.

Key financial indicators:

- Liquidity on hand
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