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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%



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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.



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### (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



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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.



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Key financial indicators:

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

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