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Rating Methodology by Sector

Consumer Finance

*This rating methodology is a modification of the rating methodology made public on July 13, 2011, and modifications are made to the descriptions and key financial indicators in narrowing down these descriptions and indicators by significance as part of clarification of rating methodology.

The following applies to consumer finance companies that extend unsecured loans to private individuals in Japan and does not apply to credit card companies, credit sales companies, mortgage companies, and business money lending 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 the industry

(i) Market scale

The consumer finance market has been noticeably contracting since the Money Lending Business Act has revised in fiscal 2006. According to the Money Lending Business Related Statistics of the Financial Services Agency, the outstanding balance of loans extended by money lenders as at the end of March 2011 stood at 26.0 trillion yen (compared with 41.3 trillion yen as at the end of March 2006). This comprises of 5.3 trillion yen of unsecured finance companies for consumers (compared with 11.7 trillion yen), 3.8 trillion yen of sales credit companies (compared with 5.3 trillion yen), and 1.8 trillion yen of credit card companies (compared with 1.5 trillion yen). The majority of the outstanding balance of loans from unsecured finance companies for consumers is believed to be unsecured loans, although secured loans are also included. The outstanding balance of loans from unsecured finance companies for consumers peaked at 12 trillion yen in March 2003. It then started to drop significantly, to 11.7 trillion yen in March 2006, 7.2 trillion yen in March 2009, 5.3 trillion yen in March 2010, and 3.6 trillion yen in March 2011.

(ii) Competitive situation

In the unsecured loan business, the main competitors to consumer finance companies are banks, credit card companies, and sales credit companies. However, the customer base does not overlap with those of banks and credit card companies of banking groups in terms of salaries and other customer attributes. Before the Money Lending Business Act was revised in December 2006, competition in the consumer finance industry was very severe; the industry consisted of five major companies and other

small and midsize money lenders. In light of the high profitability, a feature of the consumer finance business, there were even players who entered the business from the IT, railway, and other non finance industries. However, since the revision of the Money Lending Business Act at the end of 2006, given the application of stricter regulations, the decline in risk taking ability, and the increase in the number of excess interest payment claims, the number of money lenders and the outstanding balance of loans have been declining steadily. Aiful Corporation and Takefuji Corporation, the two major money lenders, went bankrupt, filing for Alternative Dispute Resolution (ADR) in September 2009 and for bankruptcy in September 2010, respectively. Certain foreign companies also withdrew from the market. As a result, at present, only a limited number of major companies are still extending new loans.

(iii) Customer bases and sales methods

The number of the populations aged between 20 years old and 64 years old in Japan is approximately 75 million, and that of salaried workers is approximately 46 million. The majority of users of the consumer finance companies are believed to be those with an annual salary of 5 million yen or less, or with an average annual income of around between 2 million yen and 3 million yen. The number of people who are categorized as people with an annual salary of 5 million yen or less by salary level is approximately 32 million (accounting for 70% of the total working population). Although they have halved compared with the figures several years ago, the number of customers of the four major companies as at the end of March 2010 was 6.03 million, and the number of newly acquired customers in fiscal 2009 was 460,000. Considering these factors, although the market is still contracting, there is apparently a certain level of need. Although it is reported by money lenders, the reluctance on the part of borrowers to take out loans to protect their living conditions is another reason for the contraction of the market.

Until around 2006, consumer finance companies built customer recognition using advertising, mainly through television, newspapers, and the internet. They encouraged customers to use unmanned loan machines, and extended loans to customers instantly when they needed them. This was then the main methods of extending loans. Since the revision of the Money Lending Business Act, excessive advertising and TV commercials have been regulated, and the content of advertising has become less direct. Given the rise in the public attention on the issue of heavily indebted people and the revision of the Money Lending Business Act, consumer finance companies have started to open consulting-type stores in recent years. Their traditional sales method was to increase the unit amount of loans by attracting customers through heavy advertising. With the circumstances described above, however, consumer finance companies are now in the phase of changing their sales method to a style in which, with the introduction of regulations that limit the total amount of loans to individual customers, they aim to acquire customers who need limited loans, but who will remain as customers for a long time, by applying more careful credit examinations. From an even longer-term perspective,

the consumer finance companies will need to respond to the effects of the declining birthrate and the aging of Japanese society.

(iv) Regulations

The consumer finance companies are required to register under the Money Lending Business Act. They are not in the position in which they can expect public support in the same manner as banks do.

A. Change of the upper limit for loan interest rates

Following the revision of the upper limit of interest rates stipulated in the Investment Act in June 2000, the upper limit of loan interest rates was lowered to 29.2%, from the 40.004% that was previously used. In the case of money lenders, until recently, when certain requirements were met, they could use interest rates in the range between the upper limit of interest rates stipulated in the Investment Act and that of the Interest Rate Restriction Act (the so-called grey zone interest rates). As a result, many money lenders were managing operations based on the interest rate range mentioned above. However, following the revision of the Money Lending Business Act at the end of 2006, the enforcement of Article 4 meant that, from June 18, 2010, the upper limit of interest rates in the Investment Act was lowered to 20%, abolishing the grey zone interest rates. As a result, the upper limit of interest rates has become the level stipulated in the Interest Rate Restriction Act (between 15% and 20% depending on the loan amount). Loans with interest rates that exceed the upper limit as stipulated in the Interest Rate Restriction Act are invalid under civil law, and can be subject to administrative penalties. Loans that are extended with interest rates that exceed the upper limit as stipulated in the Investment Act are subject to criminal punishment.

B. Revision of the Money Lending Business Act

The Money Lending Business Act was revised (and adopted) in December 2006, reflecting the importance of solving the issue of heavily indebted people and the importance of the role that the money lending business plays in the economy. Accordingly, the legal restrictions were strengthened in stages over approximately three and half years, from the enforcement of Article 1 in January 2007 to that of Article 4 in June 2010. The main features of the revision were the strengthening of the requirements for the registration of money lenders, the establishment of a system for a designated credit information organization, the strengthening of rules on excessive loans, and the lowering of the upper limit of interest rates (as described in (i) above). The resultant effects that money lenders particularly felt were a decline in risk taking ability, as a result of the lower upper limit of interest rates, and the establishment of an upper limit of loan amounts, as a result of the introduction of the restriction on the total loan amount. As a result, the operations of money lenders are now restricted in terms of both the amount (the outstanding balance) and rate (interest rates). This has significantly impacted the operating results and management strategies of money lenders. Coupled with the burden of meeting excess interest repayment claims (described below), the number of withdrawals from the business and the

number of the bankruptcies of small and medium companies has increased.

(v) Excess interest repayment claims

In January 2006, the Supreme Court decided to radically change its judgment standard related to the application of the rules of deemed reimbursement, as stipulated in the former Money-Lending Business Control and Regulation Law. Following this, the deemed reimbursement rules of the former law were to all intents and purposes dead. The subsequent surge in demands for the repayment of excess interest has significantly impacted the management of not only consumer finance companies, but also other money lenders, including sales credit companies and credit card companies. The change of the standard by the Supreme Court suddenly inspired deliberations on revising the Money Lending Business Act (formally the Money-Lending Business Control and Regulation Law) as described above, and became one of the factors attributable to the revision of the law (as described in 4) (ii) above).

(2) Market position and competitiveness

Consumer finance companies extend small loans to a large number of customers through advanced computerized operations that are based on a manual. As a result, economies of scale are a feature of the consumer finance business. It is consequently always important for the business to acquire and maintain a certain level when it comes to the outstanding balance of loans and number of customers.

Before the revision of the Money Lending Business Act in 2006, consumer finance companies sought to bolster their product and corporate image, particularly through commercial messages on TV that used celebrities and pets. These activities then played a significant role in attracting customers. In addition, because the loyalty of customers was not intrinsically high, the key point for customers when selecting a consumer finance company was the ability of the company in question to promptly lend them money. Since the revision of the Money Lending Business Act, however, the situation has changed completely, and sales performance is now determined by the ability to raise funds and by financial strength.

With the earnings and financial situation made difficult by the outflows of cash due to excess interest repayment claims, consumer finance companies are finding it hard to carry out aggressive sales initiatives. In these circumstances, advertising activities through commercial messages on television and in other media have slowed, and credit examination standards are more severe. As a result, the number of new customers acquired by consumer finance companies has halved. It is necessary for consumer finance companies to create their own new image, one that will boost recognition from general society and give customers the assurance to encourage long-term relationships. It will apparently take more time before the consumer finance companies can move away from the effects of the excess interest repayment claims and the collapse of major companies. Over the medium to long term, however, the consumer finance companies will be looking for the opportunity to restart active sales to halt the fall in

the number of customers and the outstanding balance of loans. Funding capabilities, management policies, sales initiatives, and the availability of support from shareholders are factors that differentiate the companies in terms of their competitiveness. As an example of support from shareholders, some consumer finance companies that are members of banking groups have bolstered the outstanding balance of guarantees to a certain level through the use of the sales foundations of banks and with the banks' cooperation.

Sales foundations are evaluated based on main channels, the strength to control those main channels, the number and the degree of dispersion of customers, the balance of channels and product services, and an analysis of the strengths and weaknesses. A good balance of risk and return, which is also related to the strength of sales foundations, is an important factor in examining the continuation of the business.

The operations of consumer finance companies are supported by alliances with major financial institutions in various aspects, including funding, the expansion of the guarantee business, the development of overseas businesses, and the acquisition of customers. Since the revision of the Money Lending Business Act, the effects on operations from this support have become more apparent.

(3) Management

JCR focuses on certain aspects, including (i) the constitution of managers and the stability and the independence of management, (ii) the strengths and the weaknesses of each company in light of opportunities and threats in the business environment (the SWOT analysis), (iii) governance, and (iv) the degree of risks against harmful rumors.

As a result of two events—the sharp rise in the number of excess interest repayment claims and the revision of the Money Lending Business Act—the management environment for money lenders has changed dramatically. Consequently, the money lenders have been forced to respond to changes and adopt reforms. Excess interest repayment claims have resulted in heavy unexpected expenses, and the revision of the Money Lending Business Act has lowered the profitability of loan operations. In response, consumer finance companies have made extensive efforts to streamline their management over the last few years. With the deterioration in their operating environment, instances of consumer finance companies choosing to become members of groups centered on mega banks have been rising. With respect to companies that are already members of certain business groups, JCR interviews them and examines the outlook of their roles and status within the relevant group. For companies that do not belong to any business groups, to determine whether or not they can continue to operate independently, JCR examines the overall balance of the business base, profitability, and financial strength, along with funding capabilities and other relevant factors.

2. Financial base

(1) Capital adequacy

JCR examines if consumer finance companies have adequate shareholders' equity in terms of both quality and quantity against the risks they are taking. With respect to the quantity of shareholders' equity, JCR examines the absolute size of shareholders' equity and its size in relation to the level of risks. With respect to quality, JCR examines the level of capital that relies on tax effects and securities that have a fixed term or that can be redeemed. It also analyzes the level of the equity ratio (by making adjustments to off balance-sheet transactions, deferred tax assets, goodwill, and other items, when necessary). To determine the scale and details of risks, JCR comprehensively examines the main businesses (the core businesses of the consumer finance industry are unsecured loans, the guarantee business, and the servicer), the details of assets, and the sales foundations. As a result of excess interest repayment claims, the financial strength of the consumer finance companies has deteriorated significantly. Consequently, JCR also examines whether or not the consumer finance companies have the level of capital and allowances that is adequate for dealing with risks that may take place in the next three years or so.

Key financial indicators:

- ■ Equity ratio
- ■ Equity ratio after adjustments for off-balance sheet transactions

(2) Quality of assets

JCR examines the ratio of operating assets in light of asset turnover (the average maturity period) and liabilities (the coverage ratio of liabilities by assets). It also examines the degree of dispersion of borrowers and claims, the ratio of non-performing loans, the rate of write-offs, the collection rate, unrealized losses, and the adequacy of the allowance for non-performing loans. JCR also looks into channels for acquiring assets, operating positions, credit policies, and the structures of management and collection from a qualitative perspective. Because there is a chance of a mismatch between the periods of management and funding (the so-called duration gap), it is important to pay close attention to the extension of the collection period of assets that are under management.

The consumer finance, credit card, and sales credit industries face a unique issue in the form of interest repayment loss. The provision for a loss on interest repayments is a new provision that was established in response to the sharp increase in excess interest repayment claims in 2006. Analyzing this allowance requires special attention, because each company has different reporting methods. First, the difference between the provision for the loss on interest repayment and the allowance for doubtful accounts needs to be clarified. When excess interest is repaid, repayments can be made by offsetting against the principal (principal offsetting), or, if the principal is not large enough to offset repayments, the companies make repayments using their own funds (cash-out). Accordingly, there are two methods for reporting the provision for the loss on interest repayments. One method is to include both principal offsetting and cash-out in the scope of the provision for the loss on interest repayments. Another method

is to only include cash-out in the scope of the provision for the loss on interest repayments, and include principal offsetting in the allowance for doubtful accounts. Consumer finance companies are free to adopt either of these two methods. For this reason, to compare provisions among the companies, it is often easier to analyze provisions based on the total allowance for doubtful accounts and the provision for the loss on interest repayments. Second, there are two methods of recording provisions. One method is to provide an allowance for all expected future excess repayments at once. The allowance is only reversed (objective use) when necessary. Based on this method, expenses related to the provision for the loss on interest repayments are not incurred in ordinary terms, but only in the term when the provision is made. Another method is to recalculate the amount necessary for the provision for the loss on interest repayments at the end of each term, and if the outstanding balance of the provision (after the reversal is made for each purpose) is short of the amount calculated above, an additional provision for the loss on interest repayments will be made. Under this method, the provision for the loss on interest repayments is recorded in the income statement each term. Consumer finance companies are, once again, able to adopt either of these two methods. Close attention needs to be paid to consumer finance companies that adopt the first method, because if problems of excessive interest repayments persist longer than initially anticipated, the companies will take additional measures, and a noticeable impact from these measures tend to appear suddenly. With the number of excess interest repayment claims being declining year-on-year for each business category, it is considered that changes are becoming apparent now in the trend. However, it is necessary to watch closely when the problem of excess interest repayment can end and how much allowance for loss on excess interest repayment can remain at that time.

Key financial indicators:

- Delinquency rate
- Write-off ratio
- Allowance coverage ratio
- The number of disclosure requests (when available), the number of repayment requests, the amount of repayments, and the damage to the principal, and other matters related to interest repayments
- Credit costs against operating assets
- Credit costs against accounts of profit and loss in the term
- The outstanding balance of loans per customer on average

(3) Earnings Strength

JCR analyzes profit stability, the asset income ratio, and the cost structure. Consumer finance companies make most of their income in the form of interest from loans, guarantee commissions, and other income. However, interest from loans has been falling consistently, in step with the decline in the outstanding balance of loans and the drop in interest rates. Therefore, the stability of income is clearly affected by the scale of the outstanding balance of loans, the level of guarantee commissions and other supplementary income. When analyzing return on assets (ROA), JCR refers to the figure that is

calculated by dividing the sum of total assets and operating assets by the sum of income before credit costs, ordinary income, and net income. As for indicators for the efficiency, JCR focuses on indicators per employee (the outstanding balance of operating assets and loans, and earnings) and the overhead ratio (OHR: Selling, general, and administrative expenses excluding expenses for doubtful accounts/gross profit). If the amount of loans and the outstanding balance of loans continue to decline because of the contraction of the scale of the business, the companies' operations are nearing breakeven point. In this case, it is also very important to focus on the progress and the possibility of business restructuring.

Key financial indicators:

- Indicators per employee (the outstanding balance of operating assets, and earnings)
- OHR
- ROA
- Investment yields

(4) Liquidity

It is important to note that funding is purchasing for the consumer finance companies, and it is the key factor that directly impacts on not only earnings, but also management stability and credibility. Consumer finance companies have a slight duration gap between fund management and financing, and the burden of meeting excess interest repayment claims. As a result, even in normal times, they finance their debt repayments through refinancing, securitization, and other funding measures, in addition to free cash flows. Consequently, when evaluating consumer finance companies, significant consideration is given to maintaining stable trading relationships with financial institutions to ensure that refinancing and the roll-over of CP is carried out smoothly, and to spare funding capacities or short-term liquidity in dealing with temporary turmoil in the market for direct financing. In particular, from around the time the Money Lending Business Act was revised in 2006, financial institutions have adopted a much more severe stance in extending loans to the consumer finance industry, and this is unlikely to change in the near future. It is therefore critical for consumer finance companies to have core financial institutions and to maintain sound relationships with them. When a consumer finance company has a bank as its parent company or as its main shareholder, that company is often judged to have secure funding foundations. On the other hand, if a consumer finance company has poor funding capabilities, it often fails to bolster operating claims or even reduce such claims, due to the financial restraints. It will face a contraction in its operating foundations and may eventually fail in the worst-case scenario. For this reason, close attention needs to be paid to such a company.

With respect to financing, JCR examines the balance between long-term financing and short-term financing, the balance between fixed interest rates and variable interest rates, the balance between direct financing and indirect financing, the constitution of financial institutions from which loans are extended, the constitution of methods of direct financing (including SB, CP, and credit securitization), the level of

interest rates for loans payable, the provision of collateral, and the policy and practice of covenants. Based on this examination, JCR judges whether or not appropriate financing is carried out from the perspective of funding stability and costs.

With respect to long-term financing, JCR focuses on repayment and redemption schedules, and confirms whether or not there is a time in the future when a large amount of funds will need to be repaid. If there is such a time, it also confirms the policies of the company on financing (and collateral, if necessary) for such payments.

If covenants are attached to syndicated loans, credit securitization, and other instruments, JCR examines the possibility of applying those covenants and, if they have been applied, looks at the kinds of agreements that have been made. If the possibility of applying these covenants is judged to be high, JCR examines the policies for preparing for such an event and measures taken, as well as the reality of the policies.

Key financial indicators:

- The level of short-term liquidity
- The direct financing ratio and the short-term financing ratio
- The provision of collateral

(Note) Individual companies are analyzed based on multiple perspectives, including capital adequacy, asset quality, management, earnings, liquidity, sensitivity to market risk (CAMELS), operating base (franchise value), and parent-subsidiary relationships (support) in addition to such external factors as the business environment. The order, importance, and levels of assessment weight are not related, and a comprehensive judgment is made based on multifaceted examination and these aspects. Similar to the way the balance between risk and return is emphasized, these factors are also connected to one another for additional analysis.

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