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Rating Methodology by Sector

Credit Sales and Credit Cards

1. Business base

(1) Characteristics of the industry

Credit sales and credit card businesses both involve providing consumers with credit by advancing payments for the purchases of goods and services. In the credit sales business, a credit sales company advances funds to stores that have signed membership agreements with them when consumers purchase goods or services using installment payments. The company later collects the payments from the consumers. Similarly, in credit card business, a credit card company advances funds to stores that have signed membership agreements with them when consumers purchase goods or services using a credit card issued by that company, which then later collects the payments from the cardholder. Many credit sales companies also engage in the credit card business.

Both types of companies may provide their cardholders with loans in the form of cash advances and credit card payment loans, and the interest on these loans is one of their most important income sources. In cooperation with banks, many credit sales and credit card companies provide guarantees for personal unsecured bank loans signed at teller windows and earn income from the guarantee fees.

Transaction volumes for both types of business tend to be tied to trends in consumption. While the credit card business is linked to general trends in consumption, credit sales are more connected with specific industries, such as cars and home appliances and, thus, face higher exposure to the risk of fluctuations.

While consumer needs for payment advances for purchases are stable in the long run, the size of the credit sales market has been shrinking in relation to the generally continuous high growth of the credit card market. The former is facing a major challenge in terms of its market growth potential.

Both the credit sales and credit card businesses provide customers with advance funding. Credit card companies carry a relatively small amount of asset risk, as most of their operating receivables are from cardholders with single payment plans, similar to a fee business. Meanwhile, the credit sales business consisting largely of installment payments and credit card companies carrying large portions of installment and revolving payments are exposed to some customer credit risk in their operating receivables for a certain period of time, similar to an asset business earning effective interest income.

(2) Key factors in market position and competitiveness

JCR identifies the business details of the companies to be rated and their strengths and weaknesses in comparison to their competitors. This analysis is closely related to the analysis of earning power described later in this article.

For credit sales companies, the inclusion of member stores selling cars, home appliances, jewelry, and kimono fabrics establishes an important sales base.

For credit card companies, such a base is established by the inclusion of a large number of member stores in diverse business areas, as credit cards are used to purchase an array of goods and services. Because bank-affiliated credit card companies have a longer history of credit card business than do card companies affiliated with credit sales and distribution companies, the weight of acquiring earnings is relatively large.

For credit card companies, having a large number of cardholders who contribute to earnings is a more important sales base. These are, first, those who pay annual membership fees; second, those with a high rate of card use and who purchase more expensive goods and services; and third, those who pay installment (revolving payment) fees. Further contributions are made by cardholders who frequently borrow money using their cards. The prevention of debt is important in all cases.

Credit card member store commission rates have been declining due to competition over member stores. Standard rates vary, depending on the industry of the member stores, and industries growing rapidly in recent years tend to have low commission rates, resulting in a continuously declining average commission rate. Therefore, earnings from member store commissions have not been growing as much as the growth in the volume of the business, and this gap requires attention.

For bank guarantee operations, whether cooperation has been established with banks having a large number of potential customers is important.

In addition, some companies have established separate sources of income, such as undertaking the operation of administrative processing of other credit card companies to receive service fees, getting involved in inter-company settlements, and providing loans specializing in specific areas (e.g., funds to acquire an investment condominium).

From such a perspective, JCR analyzes, in each individual case, how the company to be rated attempts to expand its business base and increase its earnings.

(3) Management strategy and policy

The management environment surrounding credit sales and credit card business changed drastically as a result of two incidents that occurred in 2006—a Japanese Supreme Court ruling that triggered a rapid increase in interest refund claims and the resulting amendments to the Money Lending Business Law. The demand for return of overpayments resulted in an unexpectedly large amount of expenses for the companies involved, and the amendments to the Money Lending Business Law reduced the profitability of loan operations. Companies carrying a large weight in loan operations and those with a long history of loan operations were particularly affected by such changes. Many credit sales and credit card companies operate loan businesses, not a few of which had relied on the earnings from loan business and neglected the earnings from credit sales and credit card business. Consequently, responses to the demand for return of overpayments and amendments to the Money Lending Business Law and

Installment Sales Law have been the largest challenge to most companies in this industry since 2006.

The direction being taken by many companies is to reduce the weighting of loan operations and increase the weighting of other businesses. In doing so, many companies in the credit sales business aim to develop new business areas, given the current declining market, while companies in the credit card business seek to increase the rate of credit card use and promote revolving payments. Also, because earnings are reduced by changes in the environment, companies seek to improve their management efficiency in different ways.

The deteriorating management environment of the entire industry is leading to megabank affiliation by both credit sales and credit card companies. For companies that are already affiliated with a group of companies, JCR interviews and studies their future roles and positions in their group. For companies that are not affiliated with other companies, JCR interviews and examines their business bases, earnings strength, and financial standing to assess whether they are capable of surviving on their own and surveys the possibility of their joining other companies' groups if necessary.

For companies that are affiliated with other companies, credit enhancement is applied to credit rating depending on the level of their connection with their group. JCR focuses on banks' credit card strategies for bank-affiliated credit card companies and the positioning of credit card companies in sales promotion and other strategies of distribution companies for distributor-affiliated companies.

2. Financial base

(1) Earnings strength

(i) Analysis of income management and measures for increasing income

Through the analysis of earning power, JCR identifies a rated company's ability to generate cash flow and quantitatively evaluates its strengths and weaknesses. In doing so, it focuses on the perspectives described in the section, "Important factors in market position and competitiveness."

For credit sales companies, actual credit sales business generally produces low profit, and other businesses, such as credit cards, help to ensure the profitability of the entire company. Credit card business earnings were supported by loans prior to the amendments to the Money Lending Business Law, which significantly reduced such profitability. Since then, companies have been seeking to increase their profits from card transactions. Analysis of the earnings strength of each company should be performed based on its management environment. In addition, the analysis must focus on the low profitability of credit sales business and reduced earnings from loans in general due to the revised Money Lending Business Law—a management environment common to all companies.

Operating income related to credit card business is announced every three years in "*Field Survey of Specific Service Industries*", a Ministry of Economy, Trade and Industry (METI) report, which categorizes (1) income from initial fees and membership fees; (2) service fee income from members through sales credit business; (3) service fee income from consumer finance business; and (4) service fee income from member stores. Analysis based, the report makes it easy to compare statistics. An

examination of these four divisions suggests that the large amount of income in (1) reflects consumer desire to own a credit card despite having to pay cardholder fees, suggesting a strong business base that includes a card’s brand power. Income in (2) is focused on installments and revolving fees, and (3)-type income is connected to loan interest rates. A large amount of income in these categories suggests a high need for such services. In particular, a large amount of income in (3) requires a concentrated investigation into the effects of a rapid increase in demand for return of overpayments and moneylender system reforms. A large amount of income that does not fall under any of these categories often reflects the company’s own strengths, which are investigated to identify the operations on which the income is based.

To understand the strengths and weaknesses of a company to be rated, financial reports related to each segment used for the internal management of the company should be obtained and analyzed. Understanding the financial results using the basis employed by the company for planning and tracking the results facilitates the discussions during interviews.

Based on the breakdown of income by segment, JCR analyzes the segments that increase or reduce earnings and the recent profitability and growth potential of those for which growth is expected. With an understanding that personnel and non-personnel expenses must be discretionarily allocated to some extent, income management by segment is used for analysis, while taking into account how a company is attempting to use such management.

In the analysis of income by segment for internal management, differences from the data on income by segment disclosed in securities reports and other financial statements must be noted.

(ii) Caution in earning power analysis

Earning power of credit sales and credit card companies is assessed based on return on assets (ROA). Generally, ordinary income and ordinary income before subtracting bad debt expenses (EBITDA) are used as numerators of ROA. For the denominators of ROA, in principle, off-balance sheet operating receivables (securitized receivables and surety obligations) are used.

Standards for recognizing earnings require attention in an analysis of operating income. In particular, JCR examines whether installment fees received from customers and member store fees are reported using methods that correspond to the installment periods and whether a lump sum is recorded when it is paid. If both types of earnings are recorded corresponding to the installment periods, deferred installment income is recorded as a liability during the period between the receipt of payments and recording of income.

The appropriateness of reserves for rewards related to credit card point systems must also be examined. If receivables are securitized, in some cases, gains on the assignment of obligations are obtained at the time of securitization and earnings temporarily increase (earnings during the remaining period of the securitized receivables fall in response), which requires attention.

Key financial indicators:

- Ordinary income and EBITDA
- Return on assets

(2) Risk profile, including asset quality

(i) Perspective in examining asset quality

An analysis of asset quality, particularly the quality of operating receivables, is important in the analysis of credit sales and credit card companies. Operating receivables are analyzed from two perspectives: (1) the deterioration of normal receivables without undue delay and (2) the provision of financial measures, such as allowance for bad debts, for deteriorated receivables.

In some cases, the analysis of (1) can be covered under an examination of the bad debt expenses of the entire company to be rated. If appropriate, however, an analysis of the level of percentage of managed receivables (described later) resulting from normal receivables (also often understood as a function of time after receivables are generated) and its changes over time (vintage analysis) are performed. The changes are often closely related to the macroeconomic environment, particularly trends in employment, which also occur as a result of changes in the stance or method of initial credit and in-process credit of the company to be rated.

Assets other than operating receivables, such as securities and real estate, must also be focused on. When the balance of such assets is not small, the purpose of holding them, unrealized profits and losses, and their marketability should all be examined.

(ii) Analysis of bad debts

Unlike banks, non-banks, such as credit sales and credit card companies, do not have set criteria for a self-assessment of asset soundness. Disclosure of bad debts is required by the Non-Bank Bond Law, and this could be considered as one criterion. Many companies, however, have not been registered based on this law, and, thus, it cannot be used for extensive intercompany comparison.

Considering the ease of requesting and obtaining information materials and information gathering through interviews, analyses based on the credit management categories used in the credit management of each company are most practical and efficient for the assessment of the actual quality of credit. Therefore, JCR attempts to obtain the criteria for credit management categories and the balance of credit in each category. The status of a shift from normal receivables to managed receivables (credit other than normal receivables in credit management categories is commonly called "managed receivables") is obtained to help the assessment of the soundness of normal receivables.

(iii) Analysis of allowance for bad debts

Analysis of allowance for bad debts seeks to understand the range of credit for which the allowance for bad debts is allocated. Methods of applying the allowance for bad debts and applying

the provision for loss on interest refunds are available for offsetting the principal in overpayment refunds. JCR finds which method is used by the company to be rated. Companies offering debt guarantee often use a reserve for loss on guarantees for surety obligations and allowance for bad debts for compensation of loans receivable after performance of guarantee, which are also confirmed.

In the current corporate accounting system, in principle, allowance for bad debts is reported based on the requirements for the accounting for financial instruments. In actual practice, however, these requirements considerably depend on the decisions of companies, and, therefore, the basis on which the actual allowance for bad debts is calculated should be confirmed.

If the method of calculating the allowance for bad debts has been changed, the reasons for the change and its effect on income and finance must be confirmed.

(iv) Provision for loss on interest repayment

Provision for loss on interest repayment was adopted in 2006 in response to a rapid increase in demand for overpayment refunds.

In the analysis of provision for loss on interest repayment, note is taken of the fact that companies vary in two aspects—division of roles in regard to allowance for bad debts and the timing of transferring provisions.

Key financial indicators:

- Managed receivables
- Allowance for bad debts and amount of bad debts written off
- Provision for loss on interest repayment

(3) Risk management system (credit management, collection, and member store management)

(i) Credit management and receivable collection

Credit management of non-banks, such as credit sales and credit card companies, is often divided into initial credit (credit assessment to initiate a contract) and in-process credit (credit management, consisting primarily of customer payment of the principal and interest).

In rating analysis, based on the broad understanding of the above processes of credit examination and verification and review, whether a credit management system corresponding to customer attributes and characteristics has been built and appropriately improved is examined together with recent trends in the rates of approval and quality of credit.

(ii) Member store management

When a member store engages in such unscrupulous business practices as high-pressure sales tactics or not providing adequate services in regard to continuous service contracts, such as with language schools or aesthetic salons, and if customers paid the fees in installments using credit sales or a credit card, they may stop the payments as a safeguard (exercise the right of defense). The

amounts paid under individual credit contracts are generally larger than credit card payments, and unscrupulous business practices often develop into serious problems. The burden on the company is also heavy if payments are stopped. In view of eliminating in advance those member stores that could potentially cause such problems, member store management is considered important for credit sales companies. In view of consumer protection, the revised Installment Sales Law requires member store management of credit sales companies.

The conditions of member store management are examined by understanding administrative processes and analyzing how problems have occurred and whether some member stores have canceled their membership due to problems.

(4) Capital adequacy

As with other non-banks, the capital adequacy of credit sales and credit card companies are assessed based on their capital adequacy ratio (equity ratio). In the case of credit sales and credit card companies, however, both the numerator and denominator of the capital adequacy ratio should be adjusted to a certain degree in some cases. Inter-company comparisons in particular require such adjustments.

For the numerator, taking into account significant differences in the amount of deferred installment income, depending on the accounting standards for revenue recognition, the tax effect should be added, in some cases, to the deferred installment income (e.g., multiplied by 0.6) to be included in the equity capital.

As for the denominator, some off-balance sheet items, such as financing through securitization of receivables and surety obligations using bank guarantee services, should be added in some cases. Meanwhile, surety obligations using affiliated loans are on the balance sheet, which should be excluded from the total assets in some cases. In general, the denominator, including the off-balance sheet items, should be used when assessing capital adequacy from the perspective of a buffer for the quality of operating receivables. When focusing on capital as funds on hand from the perspective of finance, the guarantee should be excluded. In both cases, adding securitized receivables is generally desirable.

Key financial indicators:

- Equity ratio

(5) Financing and liquidity management

(i) Financing

Financing is important as it represents raw material procurement for such non-banks as credit sales and credit card companies. If a bank is the parent company or a major shareholder, the financial base is often considered to be solid. A company with poor performance or that lacks financing capabilities, on the other hand, may not be able to increase or have to reduce its operating receivables

due to limited finances. This must be taken particular note of as it may restrict the development of the company's business base and, in the worst scenario, lead to bankruptcy.

Financing is assessed to determine whether it is appropriate in view of its stability, cost, and other aspects by investigating the balance between long-term and short-term financing, between fixed and floating interest rates, and between direct and indirect financing as well as the composition of the lending financial institutions, composition of the means of direct financing (SB, CP, securitized receivables, etc.), level of interest rates on borrowings, collateral provided, conception and conditions of covenants, etc.

As for long-term financing, JCR investigates whether there is any specific time in the future when a large amount of funds must be repaid by focusing on the repayment and redemption schedules. If such a time is scheduled, a financing policy in preparation for such occasion (collateral policy, too, if necessary) must be confirmed.

If there are any syndicated loans or securitization of receivables to which covenants are attached, the possibility of a future conflict and arrangement in the event of such conflict will be investigated. If the possibility of a conflict is considered to be high, preparations for it will be surveyed.

(ii) Liquidity management

In the finance of credit sales and credit card companies, the largest expenditure is the advance on payments to their member stores, and the largest source of income is the collection of payments for sales from customers and cardholders. Such income and expenditures are in large amounts and generally paid on certain days every month. Because the financing pattern varies depending on the company, a financial analysis of credit sales and credit card companies is based on an understanding of the pattern.

JCR also investigates the companies' contingency plans for unexpected events to assess the possibility of financial collapse.

While the amounts of income and expenditures are relatively large in the finance of credit sales and credit card companies, bank-affiliated credit card companies enjoy a stable current account balance and solid financial base. When rating their short-term instruments, such as commercial papers, therefore, higher ratings are often given from the correspondence table of long-term ratings and short-term ratings.

Key financial indicators:

- Level of liquidity on hand
- Ratio of direct financing
- Ratio of short-term financing

(6) Credit enhancement by parent company

Many credit card companies are affiliated with banks and distribution companies. For credit sales

companies, the amount of support provided by partner banks to companies that suffered a loss in the collapse of the bubble economy and corporate reorganization activities due to that support have increased. Following the amendments to the Money Lending Business Law, bank-led reorganizations became even more frequent. As a result, many credit sales and credit card companies are currently affiliated in one way or another with banks or distribution companies as consolidated subsidiaries, equity-method affiliates, or similar entities.

While parent companies' credit enhancement is incorporated into credit ratings, just as in the case of general companies, the functions served by subsidiaries and their strategic importance are often emphasized in the case of credit sales and credit card companies. The importance of a bank's subsidiaries in the retail strategy of their parent bank and the importance of a distributor's subsidiaries in the sales promotion strategy of their parent company are often evident. If this is the case, JCR generally performs its analysis based on the management strategy publicly announced by the parent company and interviews the parent company as appropriate.

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