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Rating Methodology for Guaranty Company

This rating methodology applies to guaranty companies in Japan for unsecured and secured debts for individuals. Credit card, credit-sales and consumer finance companies are engaged in guarantee services for loans to individuals, but this methodology is not allied to these companies.[1]

1. Business Base

(1) Industrial Characteristics

Main operations of a guaranty company are guarantees of secured loans centering on housing loans and unsecured loans including card loan and student loans. A guaranty company becomes a guarantor of a debtor who gets a loan from a bank or any other financial institution, and receives guarantee charges in compensation for the service, which is its main earnings source. If the debtor is no longer capable to repay his/her debts, the guaranty company repays his/her debts in subrogation and collects the repayment based on the generated right to reimbursement. An uncollectable amount is disposed of as a write-off of claims for the right to reimbursement, which constitutes a loss for the guaranty company. The above is a general business model of a guaranty company. Its balance sheets basically consist of assets centering on cash & deposits, marketable securities, amount of claims for the right to reimbursement, etc., liabilities such as unearned guarantee charges and retirement benefit expense, and net assets. As the guarantee balance is an off-balance sheet item in many cases, its balance sheet size looks smaller. With a guarantee balance per loan being well diversified with small size in general, a guaranty company's credit concentration risk is small as compared with that of banks which have many corporate loans. A period of housing loan guarantee is often super-long, causing risks associated with uncertainty till expiration date to be large. This point is an important point in terms of rating decision also.

Guarantee charges for secured loans differ significantly from those for unsecured loans in general, depending on risks. As for housing loans, a typical case of secured loans, subrogation ratio is generally low in cases of secured loans as compared with the unsecured loans', because of strong incentives for repayment of the debtor whose home is pledged as collateral. Collection of claims through sale of collateral is also possible, enabling the guaranty company's loss on secured loans to be smaller with lower guaranty charges than that on unsecured loans. It is desirable that subrogation ratio be less than a half of guarantee charges/ debt ratio. Changes in housing loan's guarantee charges/ debt ratio are historically small and the ratio has been remaining at a low level, while borrowing interest rate of housing loans significantly fluctuates with market interest rates and

[1] Rating methodologies for credit card, credit-sales and consumer finance companies are defined, respectively.

competition. A guaranty company needs to ensure a certain level of guarantee balance and number of transactions for its stable business continuity. Growth potential of market for housing loan guarantee is limited with a decline of population in Japan, and in recent years, more and more financial institutions handle proper loan without guaranty, which may have negative impact on a guaranty company. A guaranty company is thus required to expand its business size and diversify its business.

As a guaranty company is placed behind financial institution, it is considered to be not well recognized by users (debtors). Guarantee by a guaranty company is set beforehand into loans provided by financial institutions to users, and users normally do not select a guaranty company freely. Relations with financial institutions are very important for a guaranty company in stages from acquisition of guaranty contract to management and collection.

(2) Competitive Strength

Guarantee services were provided originally ancillary to individual loans centering on housing loans, and guaranty companies established by banks and other financial institutions in their groups or those established by several companies in such industry have been historically engaged in these services. In cases of a financial institution-affiliated guaranty company, it provides services to the parent financial institution's customers. In cases of an independent guaranty company, it provides services to customers having slightly different attributes such as annual income from those of customers targeted by a financial institution-affiliated guaranty company, or customers who were not accepted by such financial institution-affiliated guaranty company. These 2 types of guarantee companies have been segregated in this way. Competition among guaranty companies is not fierce as compared with that among financial institutions at the time of housing loan selection, because financial institutions tend to give preference to their affiliated guaranty companies over independent guaranty companies and also guarantee is set beforehand into loans. Independent guaranty companies are now making efforts to expand their guarantee services to customers which are main targets of the financial institution-affiliated guaranty companies. Downward pressure might be placed on guarantee charges/ debt ratio by a request from financial institutions, depending on conditions of competition. The financial institution-affiliated guaranty companies have advantages over independent guaranty companies in the selection of guaranty companies by financial institutions. The guarantee charges/ debt ratio can become an important factor when selecting a guaranty company by financial institutions, but factors including credit screening speed, approval rate, capacity to provide services that can meet financial institutions' needs are also important. IT investment towards purposes including improvement of credit screening system is now essential to improve competitive strength.

As for business base of a guaranty company, JCR pays attention to the number of financial institutions in alliance, number of guarantees, guarantee balance, number of transactions and

transaction amount, and so on to examine stability and growth potential in addition to the conditions of competition as described above. JCR also focuses on customers' attributes and characteristics of services such as secured or unsecured. In cases of a financial institution-affiliated guaranty company, JCR takes into consideration competitive strength of the financial institution, regional economic conditions and customer characteristics of the financial institution.

(3) Management

Concerning management, JCR focuses its attention on several factors including (i) managers' structure, stability of management/ independence; (ii) governance and compliance; (iii) presence or absence of reputation risk; (iv) steadiness of operation. It should be noted that guaranty companies are indirectly susceptible to regulations on financial institutions, related regulatory authorities and financial institutions' stance on loans based on these regulations and authorities, because they are placed as companies that complement such financial institutions' operations.

2. Financial Base

(1) Earnings Capacity

A guaranty company receives guarantee charges, which should cover its business operation cost, credit costs, etc. It is desirable for the guarantee charges/ debt ratio set by a guaranty company to be able to cover these costs with sufficient margin. In analysis of earnings capacity, JCR looks at earnings stability, ROA, cost structure, and so on. Revenue recognition method of the guarantee charge revenue, a major revenue, needs to be checked. In cases where a guaranty company has a revenue source except the guaranty charges, JCR will pay attention to the degree of the revenue's contribution to the overall revenue and its stability. As ROA differs depending on a degree of risk taking, JCR also pays attention to configuration of secured and unsecured debts and makes analyses of both earnings before deduction of credit costs and those after deduction of credit costs. JCR places a great value on ROA that is calculated with total assets including guarantee obligations as denominator. As for the cost structure, JCR focuses on balance of guarantee obligations and profit per employee and OHR.

(Key Indicators)

- ROA
- Guarantee charges/ debt ratio
- Balance of guarantee obligations and profit per employee
- OHR (SG &A excluding credit costs/ Operating revenue)

(2) Asset Quality

JCR analyzes debtors' diversification/ concentration degree in terms of their attributes, regions, and

channels, loan turnover ratio, average remaining years of loans, occurrences of subrogation, presence or absence of collateral and debt recoverability, conditions of write-offs/ allowance for bad debts, maintainability of standards for write-offs/ allowance for bad debts, sufficiency of allowances for claims for the right to reimbursement and for delinquent receivables, track record in credit costs, and so forth. As for qualitative aspect, it is necessary to look at stance on credit and recovery management system. In particular for the claims recovery system, JCR pays attention to whether a guaranty company has close relations with financial institution so that it can quickly acquire information from the latter on the customer when the right to reimbursement is generated. JCR also affirms that collection is performed with a method in compliance with rules and regulations. JCR in addition focuses on whether factors such as changes to economic environment, unemployment rate, financial institution's stance on support for the debtor can have an impact on occurrences of delinquent receivable and subrogation.

(Key Indicators)

- Delinquency ratio, subrogation ratio, recovery ratio, and write-off ratio
- Allowance ratio
- Ratio of credit costs to guarantee balance and ratio of credit costs to periodic income
- Average loan balance per loan

(3) Risk Management

JCR examines how a guaranty company manages credit and operational risks of guarantee obligations including the methods and assumptions in both quantitative and qualitative ways. The management's views on risk taking, their balance with management plan, whether checks among different divisions and/or mutual checks can work are keys to the risk management. From a perspective of business continuity, JCR also focuses its attention on the backup system's adequacy and check system through multiple works.

(4) Liquidity

With receiving guarantee charges in a lump sum in advance in many cases, a guaranty company does not need to borrow money, and it has sufficient cash & deposits in a sound financial condition. This guarantee charges received in advance at once are recorded as liabilities, but other liabilities are in many cases limited to retirement benefit expenses, etc. In cases where the guaranty company invests the unearned guarantee charges in marketable securities, it is desirable to invest in highly liquid risk-free assets in order to control principal impairment. In rating, JCR places a greater value on safety and financial soundness than on profitability for investment in marketable securities, and watches carefully investment policy and risk tolerance.

(5) Capital Adequacy

JCR examines whether the guaranty company's capital is sufficient both quantitatively and qualitatively against risks generated from guarantee services, and in cases where a guarantee period is long as in the case of housing loan guarantee, JCR keeps in mind that its capital can fully resist changes in environment during the period. JCR examines the capital's absolute amount and thickness against risk amount in terms of quantitative aspects, and degrees of capital's reliance on tax-effect accounting or on securities with set maturities and securities that are to be redeemed in terms of qualitative aspects. In calculation of equity ratio, JCR places a great value on the total assets with guarantee balance added as denominator and on equity capital as the numerator with allowance for loss on loan guarantees added to it, as a widely-defined buffer, because guaranty companies normally set aside allowance for loss on loan guarantees in preparation for the loss. As for size and details of risks, JCR keeps in mind that recoverability significantly differs whether the loan is secured or unsecured and that recoverability differs significantly even among secured loans, depending on balance between collateral and loan amounts. If available, JCR refers to method of risk calculation by banks and others when they calculate their capital adequacy ratio.

(Key Indicators)

- Equity ratio in consideration of balance of guarantee obligations
- Equity ratio

(6) Credit Enhancement by Parent Company

If there are major shareholders including a parent bank and other companies, which established a guaranty company, JCR incorporates possible support from the shareholders into assessment of the guaranty company. In cases of a financial institution-affiliated guaranty company, as its debtors are customers of its parent financial institution, it is restricted for its business development, and its business size is often small. For this reason, to what extent JCR can incorporate a possibility of support into the assessment is keys to the rating. JCR decides the possibility of support based on the guaranty company's importance for the shareholders or industry, degree of their involvement and control, shareholders' intention and capability for support, etc.

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