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Rating Methodology by Sector

Guaranty Company

This rating methodology primarily applies to guaranty companies that provide secured and unsecured guarantees to individuals within Japan. While credit card companies, credit sales and consumer finance companies are also engaged in guarantee operations for personal loans, this methodology is not applied to these companies.

1. Business base

(1) Industry Characteristics

(i) Market size and growth potential

Main operations of a guaranty company are guarantees of secured loans centering on housing loans and unsecured loans including card loans and student loans. The guaranty company becomes a guarantor of a borrower who gets a loan from a bank or any other financial institution, and receives guarantee fees in compensation for the service, which is its main revenue source.

The outstanding balances of housing loans and card loans from financial institutions covered by guaranty companies have been increasing. Housing loans constitute the majority of the guarantee balance. Given the long-term and strong stock-based characteristics of this business, the market is unlikely to rapidly shrink. However, considering factors like population decline, the long-term growth potential of the loan guarantee market is expected to be limited. Regarding housing loans, attention should be paid to the trend of increasing financial institutions offering proper loans without guarantees in recent years.

(ii) Competition

Guarantees by guaranty companies are typically pre-attached to loans offered by financial institutions, meaning that borrowers do not freely choose their guaranty companies. Furthermore, financial institutions providing loans often prioritize using guarantee companies affiliated with their own group. Consequently, intense competition among guaranty companies is less likely to occur compared to competition among financial institutions when selecting a loan provider.

However, competition does exist among guaranty companies, regardless of whether they are affiliated with financial institutions or independent, driven by differences in product offerings, and there is also competition with companies including credit card and credit sales companies. While independent guaranty companies often target customer segments not served by financial institution-affiliated guaranty companies, they are also expanding their guarantees to cover customer segments targeted by financial institution-affiliated guaranty companies.

(iii) Transaction stability

Transaction stability of guaranty companies is high. The guarantee period for housing loans particularly is long. While there are cases in which guaranty companies are not able to receive their guarantee fees for the period up to the expiration of the contract period due to occurrence of loan refinancing depending on interest rate conditions and other factors, guaranty companies are not generally changed until the expiration of loan repayment period, and the likelihood of the continuation of transaction is high.

(iv) Protection and regulation

While no specific regulatory body or supervisory authority exists for guaranty companies, since guarantee operations are positioned to complement financial institutions' lending activities, it is important to note that guarantee companies are indirectly susceptible to regulations and supervisions applied to financial institutions, as well as the impact of the resulting lending stance of those institutions.

(2) Market Position and Competitiveness

Market position and competitiveness of guaranty companies are important for ensuring the stability of medium- to long-term revenues. Factors such as pricing competitiveness and response capabilities for screening and their products influence their market position and competitiveness.

When evaluating market position and competitiveness of a guaranty company, JCR evaluates the number of guarantees, guarantee balance, the number of transactions, whether the transaction value is large or small, growth potential, and stability. Since these are influenced by financial institutions, with which the guaranty company is affiliated, JCR also pays attention to their scale, number, and status of use of guarantees. For such a guaranty company affiliated with financial institutions, primary target is customers of the founding financial institutions, JCR therefore considers market position and competitiveness of the financial institutions themselves, as well as the economic conditions and customer characteristics of the region where the financial institutions are based, in addition to the guaranty company's position within the founding financial institutions.

While guarantee fee rate can be a major deciding factor for financial institutions when selecting a guaranty company, enhancing the response capabilities for screening and its products is also important for the guaranty company. Regarding these response capabilities, JCR evaluates whether the guaranty company is working to increase its screening speed as well as its response capabilities for screenings, such as detailed check for individual cases, and whether it has capabilities for product to meet the needs of users and financial institutions.

(3) Management Strategy and Governance

Management strategy and governance are factors that influence direction of the business foundation and also impact the financial foundation. Regarding management strategy, JCR evaluates whether a guaranty company formulates and executes strategies that take into account changes in the business environment. JCR also pays attention to whether the guaranty company takes into account the balance between risk and return, after confirming its risk-taking policy. For governance, JCR checks statuses of corporate governance structures such as the board of directors, business administrative structure, and internal control such as risk management and compliance.

2. Financial base

(1) Earnings Power

In evaluating earnings power, JCR checks profit level and stability, as well as profitability and cost efficiency. JCR places emphasis on ordinary income in profit evaluation. Guaranty companies must cover expenses for business operations and credit costs within the scope of the guarantee fees they receive. It is desirable for the guarantee fee rate to be set at a level that provides a leeway relative to these costs. In cases of secured loans, such as housing loans, while ultimate losses tend to become small, the guarantee fee rate becomes low. Profitability can vary depending on the degree of risk-taking. Therefore, analysis is conducted from the perspectives of both before and after deducting credit costs, taking into account the composition of secured versus unsecured loans. If there are revenues other than guarantee fees, JCR confirms their contributions to revenues and their stability.

For profitability, JCR focuses its attention on ROA. JCR uses ordinary income as the numerator and total assets plus guarantee balance as the denominator.

From a perspective of cost efficiency, JCR pays attention to OHR. Since large-scale capital investment and other investments such as those in systems are often not required for guarantee operations, OHR tends to be low. Qualitatively, JCR checks whether an efficient processing system is in place to handle numerous applications for loan screening, supported by initiatives like digitalization.

Key financial indicators:

- Ordinary income, Ordinary income before deducting credit costs
- ROA
- Guarantee fee rate
- OHR (SG &A expenses excluding credit costs/ Operating revenue)

(2) Asset Quality

Deterioration in asset quality directly leads to increased credit costs, ultimately leading to worsening business performance. When analyzing asset quality, JCR evaluates occurrences of delinquencies and subrogation payments, presence or absence of collateral, statuses of collections and write-offs, and adequacy of provisions for reimbursement claims and delinquent loans in addition to credit costs relative to guarantee balance and credit costs relative to periodic income. Since housing loans are secured by the borrowers' own residences and their incentives to repay are strong, delinquency and subrogation rates tend to become lower than those rates in cases of unsecured loans. JCR analyzes indicators based on these product characteristics. Additionally, it should be noted that housing loans have long repayment periods, causing risks associated with uncertainties in environmental changes until maturity such as economic conditions and unemployment rates to become large.

For guarantee portfolio, JCR analyzes factors such as degree of diversification and concentration for borrower attributes and geographic regions. Guarantee balance per borrower is small and diversified, resulting in lower credit concentration risk compared to banks with a higher proportion of corporate lending.

Qualitatively, JCR examines credit policies and management and collection structures. Regarding collections, JCR pays attention to whether the guaranty company has established a close relationship with financial institution, which enables it to promptly obtain customer information and swiftly proceed with collection procedures when a right to reimbursement arises.

Prepaid guarantee fees serve as source of funds for future operational expenses and refunds upon loan prepayment. Therefore, in cases of investing prepaid guarantee fees, JCR places emphasis on the safety and soundness of the investment over its profitability. JCR checks whether the guaranty company invests the prepaid guarantee fees in assets with high creditworthiness and low-price fluctuation risk to reduce principal impairment.

Key financial indicators:

- Delinquency rate, subrogation rate, recovery rate, and write-off rate
- Provision rate
- Credit costs relative to guarantee balance, credit costs relative to periodic income

(3) Capital Adequacy

Given that periods of guarantees can be long-term in cases such as housing loans, capital adequacy is important as a risk buffer against losses, considering environmental changes during that time. In evaluation, JCR focuses its attention on equity ratio and the absolute amount of equity capital. When calculating the equity ratio, the denominator includes guarantee balance. For the numerator, which is equity capital, since guarantee companies typically record provision for loss on guarantees, this provision is added to equity capital as a broad buffer. Where possible, capital ratio based on risk-weighted assets used by banks and others to calculate regulatory capital adequacy ratio is also referenced.

For a guaranty company affiliated with financial institutions, if support, primarily capital, from the closely related founding financial institutions can be anticipated, this factor is incorporated into the rating. JCR assesses the likelihood of support based on degree of importance of the guaranty company to the founding financial institutions, degree of their involvements with the guaranty company, and their willingness and ability to provide support.

Furthermore, capital margin relative to risk is assessed. JCR evaluates to what extent risks such as credit risk based on stress scenarios can be covered by factors such as equity capital and future profit. Regarding the size of risks, JCR also pays heed to factors such as the facts that there is a significant difference in recoverability between secured and unsecured loans and that recoverability within secured loans can vary based on LTV levels.

Key financial indicators:

- Equity ratio including guarantee balance and provision
- Equity capital

(4) Liquidity

Since guaranty companies often receive guarantee fees upfront in a lump sum in their guarantee operations, their needs for borrowing are low and they hold generally ample cash and deposits. JCR assesses whether guaranty companies have ensured sufficient liquidity to handle concentrated subrogation payments or prepayments. For investment assets, JCR checks whether these assets are in a state of high liquidity centering on highly liquid assets.

(5) Risk Management System

JCR checks management status of risks borne by guaranty companies, such as credit risk, market risk, and operational risk, including the methods and underlying assumptions. Evaluation on balance between management's risk-taking attitudes and business plans and capital policies is also important. No matter how excellent the risk management is, it is unlikely to be a positive factor in creditworthiness assessments, but if it is considered that there is a significant room for improvement in the risk management system, it can become a negative factor.

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