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Rating Methodology by Sector

Securities

1. Business base

(1) Characteristics of the industry

The business environment surrounding securities companies has changed drastically since Japan's deregulation of its financial markets, the so-called Japan's Financial Big Bang. Following the reforms, which included the liberalization of market entry through a shift from a licensing to a registration system and the expansion of sales channels through the introduction of securities intermediation, bank-affiliated, foreign-based, online, and other types of securities companies have all increased their shares. The complete liberalization of stock brokerage commissions in 1999, in particular, had a great impact on the business management of securities companies. Commission rates have been reduced significantly along with an increase in Internet trading, and efforts toward operational diversification have become inevitable for many securities companies. As a result, such reorganizational activities as mergers between securities companies and affiliations with financial groups have been increasing. At present, each megabank group includes large securities companies that are developing alliances with their affiliated banks, and competition is growing among the groups. Since Japan's Financial Big Bang, companies in the industry have been changing along with the diversified offering of products and services. Growth of the industry as a whole, however, has not been achieved, due to such factors as the lowering of commission rates due to increasing competition, stagnant flow of funds from savings to investment, and sluggish domestic capital market.

Among the diversified businesses of securities companies, some of the major services now being offered include brokerage, investment banking, and asset management. While earnings from asset management and maintenance services are relatively stable, earnings from brokerage and investment banking services can vary significantly, depending on the volume of customer orders, and economic conditions can have a dramatic impact on the market size itself. In investment banking, securities companies act quickly to take advantage of income opportunities, resulting in rapidly changed business portfolios, which in turn may cause significant increases in particular types of risks. In general, securities companies experience substantial fluctuations in their earnings and asset and liability values.

In assessing a credit rating for a security company, a detailed analysis of changes in profit and loss under the assumption that they will experience high volatility, rather than assessing them at a particular point in time, is more important than in other industries. JCR makes its decisions based on market cycles and changes in services associated with these cycles.

Based on their operational structures, major securities companies can be divided into large securities companies, which operate globally and offer services for both retailers and wholesalers, quasi-major securities companies, which concentrate on domestic retail services, and Internet securities companies, which provide individual investors with online trading services.

In retail securities business, the prevalence of online securities companies that provide individual investors with convenient margin trading services for stock transactions at low commission rates has been significant. Assets in custody, however, are concentrated in large securities companies, giving evidence to their large customer bases. Direct customer services at large and quasi-major securities companies also focus on the sales of bonds and investment trusts and offer services for managing individual financial assets. The development of the Internet, improvement of transaction systems, and diversification of forms of trading have been creating an environment that allows individual investors to enjoy convenience in gathering information and carrying out transactions. Securities companies need to accurately understand investors' behavioral changes and promptly respond to customer needs.

Primary players in the wholesale securities business include large securities companies and large foreign-based financial institutions that provide institutional investors with brokerage services, stock and bond underwriting services, trading services, principal investment operation services, and merger and acquisition advisory services, among others. This business is not only affected in its earnings by the macroeconomic environment but, as it may carry long-term low-liquidity assets, has a risk of incurring a serious loss from trends in stock prices, interest rates, and exchange rates. Companies involved in this business must closely observe the direction of international financial regulations and supervision and their effects.

(2) Important factors in market position and competitiveness

Any credit rating assessment of a securities company needs to take into account the inevitable effect of market fluctuations as a characteristic of the industry. Therefore, the ability to stabilize business performance as much as possible is important, in which the strength of the customer base and diversity of income sources are key determinants.

The customer base is an important factor in ensuring future earnings, which supports the turnover and covering of expenses during times of a sluggish market. Using such indicators as stock prices, the number of accounts, changes in the balance of assets in custody, and results indicated by league tables of stocks, bonds, and mergers and acquisitions as time series data, JCR examines the conditions and scopes of business in terms of both overseas and domestic investors. Because these indicators are affected by the market conditions, JCR monitors medium- and long-term trends and changes in market shares rather than temporary fluctuations, and checks for movements and structural changes in the overall industry and individual companies.

Changes in stock trading prices affect the earnings of securities companies, particularly Internet securities companies, operating mostly in retail securities businesses. JCR analyzes the causes and effects of large market share fluctuations on the future profits and losses of individual companies.

JCR focuses on changes in the number of accounts and the balance of assets in custody as indicators of the growth potential and sales strategy of individual companies. In doing so, JCR monitors not only the changes, but account activities, acquisition of affluent customers and active account users, changes in the commodity composition of assets in custody, and the effect of market price fluctuations on the amount of assets in custody.

League tables and the number of lead managers suggest the strength of a wholesaler's customer base. In addition to temporary business performance, JCR monitors changes in customer groups and each customer's share as a percentage of transactions to assess whether major customers and continuous and multifaceted transactions are maintained.

In regard to diversification of income sources, JCR examines the variation of segments, products, regions, and customer groups. In particular, JCR focuses on income from agency commissions and interest rates in the investment trust segment and the weight of stable income relatively invulnerable to market conditions, such as earnings in the asset management segment.

(3) Management strategy and policy

The environment surrounding securities companies rapidly changes, and the effects of competitive environment and regulatory changes in addition to economic and financial conditions and market trends must be accurately understood to flexibly and promptly allocate management resources. JCR further considers the ability of companies to operate dynamic businesses in cooperation with affiliated and partner companies, aiming to respond to increasingly diversified customer needs and provide products and services with higher value added.

While diversification of income sources through new operations and business acquisition is effective as a strategy for growth and differentiation, expenses and/or risk-taking may increase in the process of diversification. Expected outcomes may not be achieved, which may reduce profit and impair financial performance. Taking such aspects into consideration, JCR determines whether the diversification is appropriate in light of the size of individual companies, management policy, income plans, the amount of capital, risk management system, and other factors.

Maintaining skilled human resources and appropriate personnel allocation are important in differentiation from other companies and continuous business expansion. Particularly when a business is purchased, JCR not only surveys the progress of the overall plan, but also takes a good look at the human resources and teams playing the central roles in the operations.

The increasing importance of securities companies in the strategy of megabank groups enhances the connection in relation to capital, human resources, marketing and financing activities, and the credibility of the groups is emphasized in credit rating assessments.

2. Financial base

(1) Earnings strength

For securities companies with rapidly fluctuating earnings, JCR focuses on trends in their profit levels and profitability and changes in their net operating income structures, rather than temporary profit levels. While high market volatility makes assessment through comparison of plans difficult, side-by-side comparison is effective, in which any different movement from other companies is analyzed to find the causes and the effects on future profits and financial strength.

As noted earlier, diversity in terms of both customer base and income sources is the basis of estimating future earning capacity and stability of earnings. In addition, lowering the break-even point by attempting to make expenses variable in preparation for market fluctuations is important. In particular, JCR pays attention to changes in personnel and system expenses. Given the intensifying competition, differentiation of products and distribution channels and improvement of efficiency are also areas of focus when determining a credit rating. In investment banking operations, expertise and skilled human recourses are important in evading price competition.

Key financial indicators:

- Net operating income and ordinary income
- Ratio of ordinary income to net sales (ordinary income/ net operating income)
- Structure of net operating income
- Stock-related earnings ratio (stock brokerage commission + financial balance) / net operating income) … for Internet securities companies
- Amount of assets in custody and the rate of changes in the amount of assets in custody
- Break-even point ratio
- Ratio of personnel expenses

(2) Risk profile, including asset quality and risk management system

Securities companies increase their trading assets by using low-priced funds acquired in the market or make principal investments to operate business by temporarily using their own balance sheets, and asset liquidity for contingencies is extremely important. Despite the high liquidity of most security company assets, some wholesalers hold low-liquidity assets exposed to a high risk of price fluctuations. JCR investigates a company’s policy in regard to acquiring and retaining such assets; changes in the balance; changes in the levels of various types of risk; the balance between capital and risk; the management’s risk recognition; the conducting of appropriate management, reporting, and verification; and the executing of appropriate responses to market fluctuations. An integrated risk management system, centralized risk management of the entire group, and prompt and flexible management decisions are important for financial groups having multiple segments or affiliated companies.

Medium-term low-liquidity assets are held in principal investment operations, which may result in a large loss, depending on the environment. JCR observes the investment balance, status of asset turnover, exit strategy, and its progress.

Some overseas businesses experienced large losses the past. Given those lessons, each company has improved its risk management. Diversified customer needs, however, have made products and transactions more complex, requiring more meticulous management. In market cycles, excess risk may be taken to seek earnings. Focusing on an increase in leverage and changes in asset components, whether appropriate management is maintained must be assessed.

In general, retail securities business is considered to have a relatively limited business risk. Nevertheless, changes in management policy, such as entry into new operations, changes in the business environment, such as regulatory changes and IT innovation, and other changes may rapidly increase the risk. JCR monitors any change in risk appetite as a result of modified management strategy and assesses whether the risk is managed within the company's management capacity.

Internet securities businesses have suffered losses in margin trading and futures and option trading in the past. JCR evaluates whether the companies have established a system that allows appropriate responses to a sudden change or unexpected movement in the market.

(3) Capital adequacy

Capital adequacy affects trading operations, efforts in principal investment operations, underwriting capacity, the ability to implement diversification, and competitiveness. The amount of capital is important because the size of capital will be the last support if periodic results continue to be a loss. JCR assesses whether a capital level adequate for the risk is maintained and whether flexible and appropriate responses are made in view of future changes in capital regulations.

For large securities companies, such issues as whether a risk management system is in place and capital corresponding to the system is appropriately allocated, whether the capital adequacy ratio and Tier I ratio specified in Basel II are maintained at appropriate levels, and whether the gross leverage and adjusted leverage have not been rapidly changing are essential .

The weighting of retail securities business is large at quasi-major securities companies and Internet securities companies, and their risk is considered smaller than that of large securities companies. Ratios such as the net capital regulation ratio and gross leverage (total assets / net assets) as well as the adjusted leverage (total assets – assets related to cash/futures (repo) and other repurchase agreement transactions / total assets) are used to assess the capital adequacy. A net capital regulation ratio is not used alone to assess capital adequacy and financial soundness because the target net capital regulation ratio varies among different companies and a net capital regulation ratio higher than necessary means a problem in the use of capital.

Key financial indicators:

- Capital adequacy ratio
- Tier I ratio
- Net capital regulation ratio
- Gross leverage
- Adjusted leverage

(4) Financing and liquidity

For securities companies, stable and cost-efficient financing to quickly respond to an increase in trading assets and margin trading is the key to ensuring earnings opportunities. To prepare for such contingencies as rapid market fluctuations, whether measures to respond to crisis have been planned, whether ready liquidity funds capable of covering fund requirements for the time being are maintained, and whether stress test and monitoring are appropriately carried out must be a focus.

For financing, JCR examines the stability of short-term financing, medium- and long-term financing policy, balance between long-term and short-term financing, debt repayment and redemption schedules and the funds required, diversification of sources of financing, assets to secure a switch to collateralized financing, and relationships with financial institutions through the financing limit.

Large securities companies operating global businesses face strong demands to improve and maintain the liquidity of the entire group and maintain sources of financing in major financial markets. JCR also examines whether the acquisition of low-liquidity assets is paid with capital and long-term debt and whether funds are appropriately managed among the affiliated companies in the group.

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