Last updated: July 1, 2013

Rating Methodology for Servicer Rating

The following applies to corporations or servicers that were established by obtaining a business license from the Minister of Justice in accordance with Act on Special Measures Concerning Claim Management and Collection Businesses (hereinafter referred to as “Servicer Act”), which came into force in February 1999, and purchase specified monetary claims defined under the Act or under a mandate conduct the appropriate operation of collection business, etc. of such claims.

A servicer rating is an evaluation of a servicer for its capacity to carry out servicing business, which is different from evaluations of financial instruments or credit standing of corporations. An act to assign, provide or make available for inspection a servicer rating is different from an act pertaining to JCR’s credit rating business.

1. Outline of “Servicer Rating”

A “Servicer Rating” is an evaluation of a servicer for its capacity to carry out servicing business. The term “servicing business” here means a series of operations including not only merely claim management and collection, but also delivery of collected monies and report on collection conditions to the investors. The original operations of a servicer are purchase and collection of claims and collection under a mandate of claims, which can be handled under the Servicer Act. Collection agency business, servicing business for securitization projects, backup servicing business are also conducted as their auxiliary operations. A “Servicer Rating” is an evaluation of a servicer for its capacity to carry out servicing business including these operations widely as servicing business in a comprehensive manner. JCR evaluates a servicer from two perspectives; one is evaluation of business continuity and another is evaluation of capacity to collect claims.

When assigning a servicer rating, JCR first sets one of the categories for the servicer such as “special servicer,” “primary servicer,” etc. depending on characteristics of the servicer, and then indicates the rating for it by five grades. JCR reviews the servicer rating once a year in principle.

Category for Servicer Rating:
Special Servicer, Primary Servicer, Backup Servicer, etc.

Rating Symbols and Definitions:

S1	A very high level of capacity to carry out servicing business (hereinafter referred to as “servicing capacity”)
S2	A high level of servicing capacity
S3	An adequate level of servicing capacity

S4	Although the servicing capacity is adequate, there are some points in servicing capacity that should be improved.
S5	The servicing capacity is inadequate and should be improved.

* There might be notch differences that are indicated by a plus (+) or minus (-) sign for ratings from S2 to S4.

As described above, servicing business, to which JCR assigns a servicer rating, include wide operations. This report is not a description, assuming all of those operations comprehensively. The following are outlines and attention points in terms of rating for items, on which JCR focuses as important issues. These issues are “Business Base,” “Management,” “Staff & Organization,” “Operational Process,” “Capacity to Collect Claims,” “Operational Infrastructure,” “Fundraising,” etc.

2. Business Base

(1) Size and Competitive Conditions

According to statistics by the Ministry of Justice, the number of servicer companies that had been on the increase since records began at the end of 1999 peaked out at the end of December 2008 and at the end of December 2009 with 102 companies in number and declined in 2010 and 2011. However, the number of servicer companies increased by four companies at the end of December 2012 from a year ago. Meanwhile, the number of claims handled by servicers a year peaked out in 2008 with 13,980 thousands and has been declining since then. The number of claims handled for 2012 was 9,580 thousands. Primary reason for the decline is a decline in the number of nonperforming claims themselves owing to The SME Financing Facilitation Act, which came into force in December 2009. Under the recent conditions of shrinking servicer market following a decline in sale of nonperforming claims by financial institutions, competition among servicers, which tried to win fewer tenders each, has intensified. As a result, purchase price of claims has risen, causing profitability of servicers to fall. There have been some servicers, which weakened their business performances or worsened conditions for fundraising after Lehman Shock, owing to the deteriorated business environment. Tokyo Servicer, Inc. went bankrupt in July 2010 as the first failure of servicers, which received permission from the Ministry of Justice. Several companies have gone bankrupt since then. With termination of The SME Financing Facilitation Act in March 2013, it is likely that market size of servicers might change depending on trend in sale of nonperforming claims from financial institutions. JCR therefore is paying attention to this possibility.

JCR also pays attention to trend in Japanese economy owing to the Bank of Japan (“BOJ”)’s monetary easing policy. If asset value of real estate, etc. rises owing to the BOJ’s monetary easing policy, disposal of collateral will progress. In addition, if business sentiment improves, business conditions of SMEs, etc. can improve, increasing capacity of SMEs, etc., to repay debts. JCR expects that servicers’ collection performance will improve along with these changes.

(2) Regulations

The Servicer Act, which came into force in February 1999, was revised in September 2001 as the Revised Servicer Act with expansion of claims that can be handled by servicers. The monetary claims, which are specified assets under the Act on Securitization of Assets, claims held by SPV for securitization purpose, claims held by corporations, which entered into legal proceedings, etc., were approved by the revision as new claims to be handled by servicers. After this revision, although a proposal to revise the Servicer Act for expansion of scope of the business and enhancement of the acts was submitted to the Diet in July 2009, it failed to revise the Act and was dropped.

The Ministry of Justice amended the guideline for administrative processes in July 2010 to respond well to changes to the environment surrounding the servicer industry and to appropriately examine and supervise their operations. Meanwhile, Loan Servicers Association of Japan reviewed its voluntary rules following the revision of the guideline by the Ministry of Justice and formed new voluntary rules. The new voluntary rules encompass ordinances, rules and guideline for administrative processes practically and are practical rules like some guide books. JCR values that formation of these common standards can lead to standardization and enhancement of operational system of servicers.

It is necessary for servicers to keep pace with social and economic changes flexibly to live up to social needs. As the Servicer Act specifies limits on monetary claims that can be handled by servicers, servicers cannot respond flexibly to the social and economic needs under the Act. If business scope of servicers is expanded by revision of the Servicer Act, it is highly likely that the expansion will expand market for servicers. Expected areas of the business expansion are claim collection business of public funds, etc. (local taxes, national health insurance fees, childcare fees, uncollected balance of national hospitals, rent for public houses, etc.). JCR thinks it is necessary to watch closely trend in the revision of the Servicer Act.

(3) Business Continuity

In a situation where claims sold to servicers from financial institutions do not increase as described in (1) above, the following are essential factors for business continuity: (i) claims sourcing capacity, (ii) maintenance of a break-even point to keep a balance between revenues and expenses, and (iii) diversification of customers, channels and earnings.

In cases where expansion in scope of business as described in (2) above is anticipated, capital, human resources, and system infrastructure will be necessary when dealing with such expansion. From these perspectives, there might be a case where capacity to respond to the expanded business scope may be different. For example, a servicer with firm financial strength and creditworthiness might be a condition for bidding when accepting consignment for collection of public funds. The business continuity of a servicer is also related to the following points.

3. Management

JCR interviews with management of a servicer including representative and conducts hearings about strengths, customer base, target customers for the future, business strategy, management plan, etc.

If there are any corporations, which invest in the servicer, JCR examines its position in the group strategy, current conditions of financial assistance and human support from such investors, to what extent such supports can be extended to the servicer on an ongoing basis, etc.

Servicer is also required to have an ability to carry on its business. In particular, survival chance of servicer is an important issue in cases where the servicer plays a certain role in a securitization scheme, because its failure or worsening of creditworthiness can have a significant impact on creditworthiness of securitization products. Not only the servicer's financial structure, earnings plan, etc., but also management base and creditworthiness of its sponsor corporation, if there is any, can have a significant impact on evaluations of the servicer.

4. Staff & Organization

Abundant experience of staff is an important element that can have an impact on a servicer's capacity to collect claims. In particular, JCR looks into work experiences of staff in sales and collection divisions by management and non-management class. JCR thinks highly of not only experiences of servicing business, but also other experiences such as experiences of loans at banks and professional qualifications such as real estate appraiser or certified tax accountant as meaningful.

When staffs with various experiences and knowledge gather and they bring together the power organically in accordance with the company's business direction, it may allow the servicer company to exert a high servicing capacity.

Various kinds of systems that are arranged to improve skills of staff are also areas of JCR's concerns. The representative examples of these systems include training and study sessions both inside and outside the company, incentive system for obtaining professional qualifications, and on the job training ("OJT"). JCR examines effectiveness of these systems in terms of contents, frequencies and participation rate for training and study sessions and also presence of incentive systems for taking training courses as for the external training. The OJT is a training for applying the acquired knowledge. For example, ability to negotiate with debtors cannot be polished by means other than experiences through OJT.

In cases where retention rate of staff is low, it can be said that such organization lacks stability in general, and JCR considers it a negative factor. In such a case, JCR examines whether there are any hidden problems with personnel evaluation, system of salary or bonus, or corporate culture in details. While the organizational problems are largely related to the following operational infrastructure, JCR focuses its attention on whether there are any factors for obstructing efficiency or whether mutual check-and-balance system between sales and collection divisions is functioning.

5. Operational Process

When a servicer purchases claims itself and collects the claims, it needs to evaluate purchase price based on probability of collection. A series of these operations is called a due diligence, which can be performed for individual claims in accordance with types of claims, amount of claims and the number of them, or performed for an entire pool consisting of a large number of these claims.

JCR focuses on whether the servicer ensures a structure where it can adopt an appropriate method depending on cases. As a matter of course, incentives for higher evaluation work at the sales division, which is a contract point for sellers, incentives for lower evaluation work at the collection division. In this case, it is important that an internal process for price decision be ensured.

Next, JCR checks proceedings with respect to how collection of claims is performed in details. For example, JCR checks the following: In what way and by whom collection policy or collection plan is decided; How are they in terms of contents? How often does a servicer check conditions of progress in collection? Or in what way collection of claims is actually performed.

Meanwhile, in cases where a servicer collects claims, being entrusted with the collection by another, or collects debts on behalf of another, it should deliver the collected monies to the clients or investors promptly and make out a servicing report. In these cases, therefore, JCR examines firmness of administrative work such as procedures for a remittance or creation of report, degree of automation for the procedures, records of accidents in the past, etc.

JCR also checks records of internal and external audits and inspections. As a servicer is defined as a stock company with a stated capital of 500 million yen or more under the Servicer Act, it is a large company under Companies Act, which is required to receive an external audit. Additionally, it receives a check on its legality of its operations by way of on-site inspection by the Minister of Justice. JCR further thinks that it is desirable that the internal audits and inspections be conducted periodically. Through these audits and inspections, inefficiency in operations and wrongdoing by employees can be eliminated. JCR also checks compliance system and always checks contents of lawsuit if the servicer itself is accused and examines whether the system and/or lawsuit can have an impact on sales and collection activities for the future.

In cases where a servicer is engaged in collection business or backup servicing business in a securitization scheme, timely payments of the collections to the investors will be required. Whether the service has a contingency plan in preparation for events such as natural disasters, blackout, system crash, etc. is important. JCR checks points centered on whether storage of data is diversified, whether staff and facilities are arranged for such events or whether training for recovery has been implemented.

6. Capacity to Collect Claims

In addition to qualitative evaluations such as operational process for claim correction as described above, JCR also checks the internal rate of return or IRR for each pool of claims, purchases of claims for every fiscal year, actual performance of collection, cash flow conditions, etc. to examine capacity to collect claims quantitatively. JCR examines whether a servicer ensures profitability stably to a certain extent by conducting an appropriate due diligence that matches its capacity to collect claims under circumstances where purchase price of claims is on the rise owing to a decline in nonperforming claims. In cases where a servicer does not have a large portfolio of purchased claims, there are cases where actual collection performance can change significantly depending on a fiscal year due to collections of specific large claims. JCR evaluates the servicer's capacity to collect claims, taking into account presence of such specific factor and impact of such factor, etc. appropriately.

7. Operational Infrastructure

Typical examples of operational infrastructure include system, manual, network with forces outside the company.

(1) System

It is essential that information on claims be managed appropriately for the purpose of efficient claim collection. Information that should be managed includes conditions of originator of the claims, attribute information of debtors, progress in collection, security interests, conditions of guarantor, etc. In cases where a servicer handles a large number of claims at one time, in particular, information volume is enormous, and system plays an important role. Flexibility and expandability in system design are important elements. When dealing with a large number of small claims, how the servicer can save labor of data transfer and how speedy it can perform this job additionally in case of backup servicing business are important. It is desirable that the day-to-day writing of an invoice or notice be automated from perspectives of labor saving and prevention of errors.

JCR also checks internal management & operational system, support system by outside maintenance companies, etc. In particular, JCR checks also how often data are backed up and how they are saved in preparation for breakdown or disaster, procedures for data recovery, expected time to recovery, and whether security countermeasures against unauthorized access and computer viruses are satisfactory.

(2) Manual

Staff of servicer needs to understand the common rules including the related laws and accounting system. It also needs to obtain servicing know-how of the company quickly. There are many cases where each staff member differs from one another in terms of his or her background irrespective of his or her employment status such as whether he or she is a regular employee or he or she is an assigned employee from another company. It is necessary that common procedures for operational process be established internally in order to address this problem. For this reason, a minimum manual must be prepared. It is preferable that such manual is compiled in an easy-to-understand manner and in a manner that is easy to refer to the required points. Such manual should be used frequently by staff. As legal system and social conditions change every second, it is required that time schedule for revision of such manual be set periodically.

(3) Network with Forces Outside the Company

It is important for a servicer to have a system that can allow it to cooperate with a law firm, judicial scrivener's office, accounting firm, certified tax accountant office, real estate appraiser office, etc. without delay. This system is important particularly when the servicer collects nonperforming claims. There have emerged servicers, which invest in corporations in cooperation with investment companies from a two-to-three year investment perspective for rehabilitation business. More highly developed corporate business strategy, know-how on financial strategy and wider network will be required for these operations.

8. Fundraising

A servicer needs to raise funds externally including funds from its parent company in addition to its internal funds often when purchasing claims.

As a servicer, which has a parent company, often raises funds on the back of financial support from the parent company or creditworthiness of the parent company, creditworthiness of the latter has an impact on evaluation of the fundraising capacity for the servicer. For an independent servicer, its single business performance and financial structure have a significant impact on the fundraising capacity when raising external funds in many bases, because such servicer cannot rely on credit enhancement provided by its parent company. Impact from the single business performance and financial structure has larger impact on evaluation of the fundraising capacity for an independent servicer than in the case of a servicer with parent company. When evaluating fundraising capacity, JCR checks presence of close financial institutions, lineup of financial institutions, conditions of personnel exchange including executives from the financial institutions, whether a servicer ensures an expeditious fundraising tool such as commitment line or credit line, and status of collateral management.

9. Rating Points

JCR evaluates a servicer from two perspectives; one is evaluation of business continuity and another is evaluation of capacity to collect claims. Points for each perspective are shown in the table below.

Perspective of Business Continuity	Perspective of Capacity to Collect Claims
• Amount of Equity Capital, Equity Ratio, and Quality of Equity Capital (Deferred Tax Assets, Reliance on Equity Capital to be Redeemed) • Write-off Ratio, Balance between Allowance for Bad Debts and Write-offs and Its Trend • Presence of Assets unrelated to the Main	• Actual Recovery (By the Number of Years Elapsed) • IRR for Each Pool of Claims • Scenario for Recovery and Difference Between the Scenario and Actual Recovery • Analysis of Recovery Curve, If Possible

Business and Size of Such Assets • Operating Margin, Recovery Rate for Every Fiscal Year and Its Trend • Diversification of Earnings and Claims Sourcing Channels, Degree of Diversification • Conditions of Transactions with Financial Institutions, Margin for Fundraising and Fundraising Period • Status of Collateral Management (Margin of Collateral for Fundraising) • Trends in the Number of Customers, the Number of Bids, and the Number of Successful Bids • Per-Capita Outstanding Balance of Claims, Transaction Volume, Profit/Loss • In Case of Servicers with Parent Company, Closeness with the Parent Company (Equity Capital, Management, Human Resources, Business and Fundraising)	• The Number of Years Elapsed, The Number of Claims Handled • System Volume and Margin for It • Hearings about Factors for Success and Failure in the Past

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