Rakuten Bank, Ltd.
Transcript of the 1H FY03/24 Financial Results Presentation

[Slide 4: 1H Financial Highlights]
Financial results were favorable. Ordinary income was ¥65.9 billion, up 12.8% year on year, and ordinary profit was ¥22.5 billion, up 25.4%. Non-interest income accounted for 39.5%, which is in line with our previous explanation that the ratio of non-interest income to interest income is approximately 4:6. ROE was 13.7%, indicating continued high profit efficiency. The number of bank accounts totaled 14 million, up 10.3% year on year to continue our double-digit growth trend. The main account ratio also showed favorable progress, at 31.4%. The deposit balance was ¥9.5 trillion, up 13.7% year on year, also growing by double digits, and indicating that deposits are growing faster than the number of bank accounts. The G&A expense ratio was 43.5%, demonstrating our efficiency as a digital bank, and efficiency has improved further. The capital adequacy ratio was 11.3%, remaining at a sound level.

[Slide 5: Consolidated Statements of Income]
Ordinary income amounted to ¥65.9 billion, up 12.8% year on year. Gross operating profit rose 14.8%, to ¥44.2 billion; ordinary profit increased 25.4%, to ¥22.5 billion; and net income grew 25.6%, to ¥16.0 billion.

Interest income rose 19.0% year on year, driving up overall performance during the period. Capital increased this April at the time of our IPO, and the key issue for this fiscal year is how to effectively utilize this capital to increase investment assets and raise interest income. We believe our efforts in this regard are producing positive results. At the level of gross operating profit, higher loans and trust beneficiary rights of Rakuten Card pushed up net interest income substantially.

Some categories that make up net non-interest income grew significantly, while others did not. Specifically, commissions received on exchange transactions rose substantially, as our numbers of bank accounts and main accounts rose steadily. Direct debit fees fall into two categories. The first involves direct debits to pay for electricity, gas, water, or mobile phone charges, and payments for credit card transactions. These fees related to consumer activity expanded steadily. However, account transfer fees related to entertainment, and specifically on account transfers related to publicly operated sports, fell year on year. These fees, which grew substantially during the pandemic, fell back again post-pandemic as consumers resumed their previous lifestyles. As a result, net non-interest income increased 2.6% year on year.

[Slide 6: Factors Driving Growth in Ordinary Profit in 1H]

Ordinary profit was ¥17.9 billion in the first half of the previous year, rising approximately ¥4.5 billion year on year, to ¥22.5 billion. Net interest income was a major contributing factor, while the rise in net non-interest income was only slight. General and administrative expenses increased, reflecting expenses incurred for our growth.

[Slide 7: Ordinary Income, Ordinary Profit, Net Income]

The figure on the right shows our progress against our forecasts. For FY03/24, we forecast ordinary income of ¥134.8 billion, up 11.9% year on year; ordinary profit of ¥44.5 billion, up 15.0%; and net income of ¥31.5 billion, up 13.9%. Our rate of progress toward these forecasts was slightly above the halfway mark on the profit front, being 48.8% for ordinary income, 50.5% for ordinary profit, and 51.0% for net income. Being at 50% at this stage indicates particularly good progress for a bank like ours that is growing, as our topline performance will tend to rise, from Q1 to Q2, from Q2 to Q3, and from Q3 to Q4.

[Slide 8: Credit Costs]

Credit costs rose in line with the expansion of investment assets. In the past, we developed a card loan business with loans guaranteed by Rakuten Card. In the past few years, however, the balance of non-guaranteed card loans (in which the Bank bears the risk) has risen. With non-guaranteed card loans, credit costs are naturally higher than for guaranteed loans, so in the first half, credit costs rose year on year. However, the credit cost ratio remains low, indicating that our asset quality remains sound.

[Slides 9 and 10: Net Interest Income and Net Non-Interest Income]

Net interest income and net non-interest income both rose, but the growth in net interest income was particularly high, rising 23.2% year on year.

As you can see from the bar chart showing the breakdown of interest income, investment assets can be divided into two major categories: loans and monetary claims bought. Both of these are expanding steadily.

[Slide 11: Non-Interest Income]

The pie chart on the right shows the percentage of non-interest income by type. Non-interest income has three components. The first is commissions received on exchange and settlement transactions, the second is direct debit fees, and the third is debit card commissions. These three components are pillars of non-interest income, and each of them is growing steadily.

The table on the left shows that non-interest income rose 4.1% year on year. Looking at the breakdown of fees and commissions income, commissions received on exchange and settlement transactions increased 11.3% year on year. Driving this double-digit growth was a rise in the number of bank accounts and an increase in main accounts. Within direct debit fees, we saw a substantial increase in fees that are closely linked with consumer activity, such as direct debits to pay for electricity, gas, water, or mobile phone charges, and payments for credit card transactions. However, direct debit fees related to entertainment, such as for publicly operated sports, fell year on year, holding the total rise in account transfer fees to 1.9% year on year. In card-related fees, as we explained in our Q1 results presentation, debit card transactions are growing steadily but the merchant commission rate is down, affected by the Japanese government’s efforts to promote cashless transactions. Debit card commissions were up just 1% as a result. However, the decline in entertainment-related account transfer fees was a one-time post-pandemic event, and we do not expect merchant commissions on cards to fall rapidly going forward. We believe that if we can hold out for about a year, both entertainment-related account transfer fees and card-related fees will grow in line with our capacity.

In fees and commissions, the decrease in commissions on housing loans was a negative factor. This is because we anticipate that interest rates will rise in the future, increasing the likelihood of defaults on housing loans. Traditionally, the Bank has targeted and provided housing loans to middle- and high-income customers. However, to prevent an increase in defaults due to potential future interest rate hikes, we are now raising the income bracket of our targeted customers and restructuring our housing loan business to focus on customers who can reliably repay their loans even if interest rates rise. As a result, the number of housing loans executed was down, lowering administrative handling fees on housing loans. Other operating income partly depends on the markets, but as exchange rates and interest rates have moved slightly, other operating income from foreign currency deposits, FX, and deposits with embedded derivatives steadily increased.

[Slide 12: New NISA and Bank Accounts]

The new NISA system, which begins next January, has been attracting a great deal of attention, and consumers are watching with interest. The number of new accounts at Rakuten Securities has been rising as a result. Also, this October, Rakuten Securities waived trading commissions on Japanese stocks, which has given a further boost to new securities account openings. There are two aspects to the relationship between us and Rakuten Securities: one is to direct customers who have bank accounts to Rakuten

Securities and encourage them to open securities accounts, and the other is to encourage customers who have opened accounts with Rakuten Securities to open accounts with Rakuten Bank. The latter aspect has led to a considerable increase in the number of new accounts opened at Rakuten Bank, due to the rise in new accounts opened at Rakuten Securities. The bar graph on the right shows how referrals from Rakuten Securities led to an increase in new account openings at Rakuten Bank in Q1 (April–June) and Q2 (July–September). Over the past five years, new account openings resulting from Rakuten Securities referrals have, on average, fallen by 8.7% from Q1 to Q2. This year, they were up 84.8%. We are also benefiting from the increase in new accounts at Rakuten Securities due to the new NISA system and Rakuten Securities' elimination of trading commissions on Japanese stocks. We expect to steadily acquire new accounts as part of the wide-ranging services offered by the Rakuten Group, as well as benefiting from sudden rises in new accounts when certain businesses come into the limelight.

[Slide 13: Funding and Investment]

Our main source of funds is deposits, and we have a deposit balance of ¥9.55 trillion. Our principal investments are loans and monetary claims bought, which amount to ¥3.9 trillion and ¥2.25 trillion, respectively. As the bar graph on the right shows, loans, monetary claims bought, and deposits are all growing steadily. Looking at year-on-year growth rates, deposits were up 13.7%, and investment assets (the sum of loans and monetary claims bought) increased 19.2%. Currently, investment assets are growing faster than deposits.

[Slides 14 and 15: Investment Assets]

With regard to balances as of September 30, let us start from the top with card loans. We have explained that the trend has been upward since last autumn. On their own, the numbers do not seem to show much of an increase, but recognizing that the figures disclosed in Q1 (as of end-June) reflect the bonus period helps to illustrate the upward trend shown in the ¥2.8 billion rise from March to September. Meanwhile, housing loans were down ¥4.6 billion. This figure is in line with expectations and reflects our efforts to hold back on loan executions in anticipation of higher interest rates. Affiliated loans, investment property loans, ABL, business loans, other loans, trust beneficiary rights of Rakuten Card, and monetary claims bought other than trust beneficiary rights of Rakuten Card all grew steadily. These figures are in line with our previous explanation that our investment assets will not be skewed toward any one category, but rather will grow in a well-balanced manner.

In terms of strategies to increase interest income going forward, in addition to expanding the balance of investment assets, we aim to boost our interest spread by gradually increasing our proportion of what we call middle-risk assets (investment assets that yield slightly higher returns than other investment assets). Specifically, we are steadily increasing our holdings of all four loan types in the middle-risk asset category: card loans, investment property loans, ABL, and monetary claims bought (others). We will expand our card loan balance by promoting online marketing. We plan to steadily build up our investment property loan balance by leveraging the relationships we have built with major sellers. ABL and monetary claims arise from securitization activities, and we will increase our balances of these investment assets by acquiring new securitization cases. While securitization assets are not something we can accumulate steadily on a quarterly basis, we believe we can stably expand our balance of these assets over the course of about a year.

[Slide 16: Topics Related to Improved Spreads on Card Loans]

Until March 2020, our card loan business mostly consisted of guaranteed card loans. We expanded this business through card loans guaranteed mostly by Rakuten Card. In April 2020, we started handling non-guaranteed card loans. Rather than having loans to new customers guaranteed, we take on the risk of bad debts ourselves. As the figure on the left shows, our balance of card loans guaranteed by Rakuten Card has been decreasing gradually. In contrast, the balance of non-guaranteed card loans has been growing.

From a profitability point of view, on guaranteed card loans we pay half (5%) of the 10% yield on our card loans as a guarantee fee to a guarantee company. In this case, the guarantee company bears the entire risk of bad debts, so the Bank incurs no bad debt costs. In contrast, on non-guaranteed card loans we pay no guarantee fees but we bear the risk of bad debts. Our basic idea is to control the risk of bad debts to within 3% of the 10% yield on the card loans. As we have been able to keep the loan loss ratio below 3%, our real interest margin on non-guaranteed card loans is more than 7%. Under this scenario of an increased ratio of non-guaranteed card loans, our earnings improve even if our balance of card loans remains the same. We aim to significantly improve card loan revenue by expanding the overall card loan balance while gradually increasing the proportion of non-guaranteed card loans.

[Slide 17: Capital Adequacy]

Our capital adequacy ratio stands at 11.3%, and we believe that maintaining a healthy ratio is extremely important for business stability. We generally aim to maintain the ratio at around 10%. We may tolerate temporary dipping below 10% during growth phases, but we aim to manage our operations so as not to fall below 8%. We consider the current 11.3% to be a healthy level for a domestic bank.

[Slide 18: General and Administrative Expenses]

Our G&A expense ratio is 43.5%. We have explained the Medium- to Long-Term Vision targets G&A expense ratio of less than 45% by FY03/27. We have already met that target this year, in Q1 and Q2. As we have explained, even if we keep the G&A expense ratio below 45%, lowering it to 40% will be a challenge. Although we cannot guarantee that we will be successful in doing so, we will seek to leverage the advantages of our business model as an online bank to lower our G&A expense ratio from the current 43.5% to 40%.

[Slide 19: ROE]

Prior to listing, we explained that the ROE would temporarily dip because of the capital increase at the time of our IPO. Fortunately, however, profitability has improved significantly, and ROE is now at 13.7%, almost the same level as on March 31, 2023. Our basic strategy for improving ROE has four components. First, we will increase the number of bank accounts, and by boosting the number of main accounts, we will cross-sell our services and those of the rest of the Rakuten Group to main account users. This should significantly expand non-interest income. Second, we will diversify and maintain balanced growth among investment assets without being skewed toward any specific asset category. Notably, by securitizing assets within the Rakuten Group, we will create unique and profitable investment assets and strengthen our risk-return profile. Third, our capital adequacy ratio is currently 11.3%, meaning we have room to apply more leverage, thereby increasing ROE. Fourth, in the digital banking business the expense burden tends to grow lighter as the scale of business expands. Accordingly, ROE should rise as we grow larger.

[Slide 20: Dividend Policy]

Our dividend policy remains unchanged from the policy as explained previously. Given the significant growth opportunities before us, we believe it is important to prioritize growth over dividends in the short term. However, in the medium term, if progress is unsatisfactory at the time we review progress toward our Medium- to Long-Term Vision, we will naturally consider reviewing our capital policy, including the payment of dividends. Our first priority is to meet the targets of our Medium- to Long-Term Vision and gain the understanding of and contribute to our stakeholders by enhancing our corporate value. The capital adequacy ratio currently stands at 11.3%, and as profits are growing steadily, we expect capital to accumulate. Some have said these circumstances suggest that we could distribute dividends. However, we intend to improve profitability and enhance corporate value by expanding our investment assets at a faster pace than we accumulate capital due to rising profits. Therefore, when considering our Medium- to Long-Term Vision through the end of March 2027, we are aiming to secure a capital adequacy ratio of around 10%. We are willing to accept a ratio below 10% during periods of growth, but we believe it should not drop below 8%. To realize the Medium- to Long-Term Vision, we prefer to prioritize growth over dividends at the present time.

[Q&A **]**

Q1

Regarding the waterfall chart for the capital adequacy ratio on page 20, what does the phrase "capital deployment for growth" mean in terms of organic and inorganic growth? How does this figure reflect the finalization of Basel III?

A1

We created the figure for the capital adequacy ratio in response to questions about whether there is room for dividends. To your question about whether growth will be organic or inorganic, we expect to expand our own capital organically by accumulating profits. However, we also anticipate that the capital adequacy ratio could fall if assets grow faster than we accumulate capital. At the moment, we have no plans for inorganic growth, so this was not part of the thinking behind this figure.

We have made various calculations with regard to Basel III. The standards will have some positives and some negatives, but on balance we do not expect to be affected significantly. I would venture to say that we expect operational risk to be slightly larger than before, but overall, this will not pose a significant problem.

Q2

I have a question about middle-risk assets on page 15. If the Bank had targets for the first half of the fiscal year, how did these results compare to them? I am also curious about the outlook, including for card loans, investment property loans, ABL, and monetary claims bought (others).

A2

We have not disclosed target figures for middle-risk assets externally, but to illustrate in relation to the Bank's internal budgets, card loans were nearly in line with our expectations. Investment property loans were slightly stronger than expected, and ABL and monetary claims bought (others) were above our internal targets set as a result of securitization activity.

Going forward, we will work to expand card loans a bit more. We would like to see a steady accumulation of investment property loans. With regard to securitization, ABL and monetary claims bought (others) could exceed first-half figures, but as that will depend on what deals are concluded, I will refrain from further comment.

Q3

I have a question about yen bond investments. I understand that previously, you were still debating this. As yen interest rates turn positive, what are your thoughts on investing in JGBs and other yen bonds going forward?

A3

Our fundamental thoughts on considering yen bond investments have not changed. We believe long-term interest rates will gradually rise, and we think the Bank of Japan (BOJ) may abandon its negative interest rate policy on short-term interest rates. If that happens, we think the BOJ would first raise the negative 0.1% policy rate to zero, and then either keep it at zero or raise it once or twice. Given this interest rate outlook, we believe that we could profit by making medium- to long-term yen bond investments using short-term funding, and holding the bonds to maturity. On the other hand, gradually rising long-term interest rates imply that unrealized losses on yen bond investments could increase, which would be another point to consider.

Our conclusion is that, while our previous yen bond investments were for collateral purposes only, now we also intend to purchase yen bonds for investment purposes. However, given their potential for losses we will need to carefully consider the scale and timing when we start making yen bond investments.

Q4

I have a question about the rate of growth in the balance sheet. I see that the rates of year-on-year growth for deposit and loan balances were down slightly from end-June to end-September. Given that your comments on loans were relatively positive, would it be correct to assume you feel no need to take any particular measures in response to this slight decrease? Could you explain how to interpret this decline in the growth rate?

A4

There is an ongoing debate about what growth rate is appropriate to use when assessing the balance sheet's growth. That said, it is natural for the rate of growth to slow as scale increases, and based on our first-half results, we see no need for any operational adjustments. For housing loans, however, we have diverged from our earlier plan as a result of implementing measures to curb growth due to emerging signs that the BOJ may be discontinuing its negative interest rate policy. From the perspective of balance sheet growth, housing loans are down, while balances of other assets are growing as planned or even slightly stronger. Netting these out, the overall growth rate looks slightly lower, but the decline in the housing loan balance has no significant impact on interest income, as housing loans are assets where we can only secure paper margins. It is important to maintain execution of our traditional strategy of balancing and expanding a diverse range of assets while controlling loan loss costs, and we do not believe there is a need for intervention due to slow asset growth.

Q5

I would like to know about your strategy regarding yields on yen deposits and time deposits. Some megabanks and large banks have issued releases indicating that they will increase yields on longer-term time deposits; is there any change to your strategy for attracting deposits?

A5

Deposits are a crucial part of our core strategy, which focuses on acquiring new customer accounts, cultivating them into main accounts, and enhancing profitability through cross-selling. If a Rakuten Bank account becomes a customer's main account, as they have their salary deposited into it, and their day-to-day living expenses paid from it, the absorption of funds through ordinary deposits becomes a key component. Of course, while we also offer attractive time deposits in accordance with customer needs, our primary method of funding is ordinary deposits; long-term time deposits are not our main source of funding. We aim to steadily increase our ordinary deposits by acquiring main accounts.

Q6

I have a question about data monetization businesses. I would like to hear about any internal developments that can be shared with the stock market with a view to expanding earnings next fiscal year and beyond.

A6

We believe data can be utilized in two major ways. It can be used to grow the top line, by using data in marketing and credit screening. Data can also be used to improve operational efficiencies further, reducing costs. Additionally, we believe that the use of data will be combined with AI.

Responding to your question about next year by looking at the near future, in marketing we are identifying prospective customers for various services and improving the efficiency of marketing by utilizing Bank data, Rakuten Group data, and AI within the scope permitted by the Bank’s regulations. We are already seeing some effects from this, and we believe the effects will be even greater next year.

In card loans, we have created a new credit screening model that uses AI to analyze data, and we have begun using this model to issue small-scale card loans. Although the amounts are not yet large, we can earn high rates of interest on this business. It is growing steadily, and we expect it to expand further next fiscal year.

During our Q1 earnings announcement, we receive a question about our data-based advertising business. We explained that while our clients understand the value of our data, we need to establish a proper system. Since then, we have been steadily making progress in developing that system, and we believe that clear numbers will emerge from our data-based advertising business.

We are also identifying areas where we can use AI and data to handle processing without human intervention. We are beginning implementation now, and we are making steady progress. We expect this effort to help reduce expenses, which should lower the G&A expense ratio. We are addressing each issue one at a time.

Q7

Do you foresee any business risks or management issues? Your financial results are extremely favorable, and the business is expanding. At the same time, the Bank is addressing future risks, such as restructuring housing loans customer base. Are there any downside risks or management issues that investors should be aware of?

A7

We do not perceive any significant business risks within the Bank. If we consider the divergence between our expectations and reality to be a risk, then we would say that a risk exists in the fact that society's move toward cashless payment is slower than we had envisioned. An increase in the cashless payment ratio would be extremely beneficial for our business, so it might not be a risk. However, we are concerned about the rate of increase in the cashless payment ratio potentially falling short of our expectations or taking more time than assumed, which could pose a risk.

Q8

Monetary claims bought (others) rose by around ¥70.0 billion QoQ. What specifically do they consist of? I believe the actual amount of Rakuten Mobile trust beneficiary rights recorded was around ¥70.0 in either March or June, so that might have contributed substantially to the increase. Or was there a significant contribution from another source? The "others" category rose significantly, so I am wondering what it comprised.

A8

You should think of other monetary claims bought (others) in connection with ABL. As a result of securitization activities, our loans to trust accounts result in ABL, and our purchases of trust beneficiary rights become monetary claims bought (others). Both ABL and monetary claims bought (others) are growing. Although the securitization assets of Rakuten Mobile are included in monetary claims bought (others), the increase in Rakuten Mobile's securitization assets is slight in the overall total. The growth in monetary claims bought (others) and ABL is composed of securitized real estate, projects, and monetary claims.

Q9

I have a question about the pass-through rate. If negative interest rates are scrapped and the policy rate rises from minus 0.1% to zero or positive 0.25%, would the pass-through rate on the trust beneficiary rights of Rakuten Card be 100, resulting in a rise of around 35bp based on a TIBOR? Regarding deposits, while I believe the short-term prime rate has increased by 25bp, I would like to understand management's current view on the pass-through rate on the asset side and liability side when interest rates turn positive, considering a general pass-through rate of 10bp (10 bp at 40%) as the most likely scenario.

A9

With regard to the pass-through rate, I understand your question to be making the assumption that interest rates move from negative 0.1% to positive 0.25%, rather than zero. As trust beneficiary rights of Rakuten Card are based on TIBOR, the pass-through rate is 100%. Interest on the trust beneficiary rights of Rakuten Card fluctuates depending on factors such as the rate of default of Rakuten Card's receivables. However, if all other conditions remain constant, the pass-through rate will be 100% when the market interest rate increases. Around 75–80% of our investment assets, which include the trust beneficiary rights of Rakuten Card, are variable-rate, and the majority of them are based on TIBOR. Therefore, many of them will follow at a 100% rate, not just the trust beneficiary rights of Rakuten Card.

The deposit side has some unpredictable aspects. In the current banking management environment, one might doubt banks would follow the traditional practice of raising deposit rates if the policy interest rate were to increase to 25bp. We maintain our ordinary deposit rate for individual customers at 2bp, while many mega banks and regional banks have set theirs at 0.1bp. When other banks lowered their ordinary deposit rates from 2bp to 0.1bp in the past, we decided that it would not be appropriate to place further burdens on our individual customers. Thus, we absorbed the burden of interest rates through management efforts and kept the rate at 2bp. In this respect, we will make our decision by referencing how much other banks increase their rates. The question is whether rates will really be raised to 10bp, or whether other banks will just return their current ordinary deposit interest rate of 0.1bp to about 2bp, and that would be the end of it. We believe there are many possibilities. Given our earning power, we have considerable assets that would follow by 100%, so if other banks raise their interest rates, we should remain profitable even if we raise deposit rates to the same extent.