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Brief Report on Displacement of Consumer Finance Market from Nonbank to Yamikin

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Abstract：

Excessive lending and aggressive collections practices by illegal lenders (*Yamikin*) have abated somewhat in the most recent Survey period. On the other hand, a new class of "softer" illegal lenders (soft *Yamikin*) are targeting borrowers who were refused credit by licensed lenders. While using collections practices that are generally less abusive and violent than hard-core *Yamikin*, These soft *Yamikin* nonetheless charge illegally usurious interest rates and engage in lending above legally set lending caps. Significantly, the Survey of prospective borrowers revealed the fact that soft *Yamikin* users not only ceased to fear *Yamikin*, but also felt a certain sense of gratitude for being able to borrow money, and were less aware that they were victims.

1. Large-Scale Shrinkage of Consumer Finance Market

The consumer finance market has been materially disrupted and a significant percentage of it displaced into the illegal sector since the adoption of the revised Money Lending Business Law (MLBL) in December 2006. The MLBL was amended for the purpose of relieving "heavily-indebted people[1]." After its adoption in 2006, the MLBL was fully implemented in June 2010, though not without lingering concern by many over its negative impact on borrowers, credit availability, financial system stability and the broader macro economy. In September 2010, Takefuji, one of the largest consumer finance companies, filed an application for protection under the Corporate Rehabilitation Law. Loan volume of the seven largest companies in this sector has fallen from 8.5 trillion yen at its peak to 3.5 trillion yen at the time of Takefuji's bankruptcy. These statistics evidence a significant contraction in liquidity for consumers and small businesses, with the market size shrinking by 60 percent in the last three and half years.

[1] There is no clear definition on "heavily-indebted people". For example, "heavily-indebted people" defined by FSA is different from that by Japan Federation of Bar Associations.

Furthermore, a surge in interest overpayment refund (*kabarai*)[2] claims, coming on top of the interest rate ceiling reductions, led to the near complete elimination of moneylenders' capability to supply funds to this market segment. Figure 1 shows recent trends in the amount of kabarai refunds paid out by the 7 largest consumer finance companies, as well as their new loan initiation rate. Kabarai claims rose dramatically following the Supreme Court's judgment[3] in January 2006 that effectively invalidated the so-called gray-zone interest rate band (20%-29.2% per annum), which lies between the civil interest rate ceiling under the Interest Rate Restriction Law criminal usury ceiling under the Capital Subscription Law, and the failure of the Diet to adopt any legislative measures to stabilize the sector. This upward trend still remains the same, raising the amount of overpayment refunds paid out by the 7 largest consumer finance companies since January 2006 to 2 trillion yen. However, survey data strongly suggest that the large surge in kabarai claims, often arranged in hasty workouts by lawyers and judicial scriveners, with a strong economic incentive for quick deals with little in the way of financial counseling, is not serving the longer term interests of rehabilitating heavily-indebted consumers.

On the other hand, as Figure 1 shows, the new loan booking rate has dropped from 55% to approximately 25%. At the initial stage of the MLBL amendment, a rapid constriction in the credit supply affected "small business owners" and "temporary workers". After the full implementation of the MLBL, given the reduction of interest rate cap and full imposition of the one third lending cap, "low income earners" and "housewives" were also affected.

2. Concerned Side Effects

Such a liquidity crisis in the consumer finance market is causing significant changes in borrowers' behavior. This article reports on the empirical findings of how the liquidity crisis

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[2] The category of interventions by lawyers and public agencies typically covers instances in which debtors are disinclined to file for personal bankruptcy and instead seek the assistance of an attorney-at-law (*bengoshi*) or judicial scrivener (*shiho-shoshi*, a legal expert in wills, divorces, and other areas) in seeking a reduction in, or exemption from, the loan principal or interest. Overpayment claims on the grounds that past interest payments were made at excessive rates in the gray-zone interest band have risen to particular prominence. Such legal moves seek redress from money-lending firms by demanding not just that the excess amount claimed is either deducted from the loan principal, , but that the lender be made to pay additional compensation in cases in which the excess exceeds the principal that the entire debt is erased. They are collectively referred to as refunds of overpaid interest (*kabarai*).

[3] Heisei 16 (Jyu) No. 1518 Loan Claim Case (Supreme Court).

is being felt at the micro level, based on the results of an ongoing survey[4] that the authors have conducted with consumer finance borrowers since 2006.

Figure 2 indicates the trends identified by the survey in the major purposes of application for consumer finance loans. While borrowing for leisure/entertainment costs (including the categories of "purchase of goods" and "travel/leisure cost") is declining, costs for daily necessities such as "supplement to living cost" or "child education cost" are increasing. It is assumed that the major part of the decline in consumer spending has been driven by decreases in borrowing for discretionary purposes such as "purchase of goods" and/or "travel/leisure cost". Also, the economic recession is a driver of the increase in borrowing for the purposes of "supplement to living cost" and/or "child education cost". Historically, consumer loans served to mitigate the liquidity gap that arose during periods of economic recession; however, the evidence suggests that due to the MLBL amendments, consumer lending is not able to function effectively in that role. Moreover, although the MLBL amendment was intended to reduce borrowings for the purposes of paying down other loans, as Figure 2 shows, the borrowings for "repayment of other loan(s)" haven't declined. Instead, "allocation to housing/car loans" is increasing. Going forward, it is highly likely that housing loan defaults will become a social issue as a side effect of the MLBL amendments.

Next, Figure 3 shows the trend of outstanding balance (median) of loans extended by "consumer finance", "bank card loan" and "family/acquaintance", which ongoing users of consumer finance hold. According to this figure, the outstanding balance from consumer finance has declined from 840,000 (2006) to 500,000 (2010) yen. On the other hand, while borrowings from bank card loan are leveling off, borrowings from family or acquaintance have risen from 500,000 (2006) to 900,000 yen (2010).

Furthermore, while there is a growing tendency that borrowers who are facing difficulties in securing further credit from consumer finance companies turn to family or acquaintances for support, those alternative sources' ability to extend support is itself weakening as a result of the MLBL amendments. As shown by Figure 4, out of those who applied for borrowings from consumer finance companies in the past year, 33.6% (2010) sought loans from "family/acquaintance", up by more than 5 points, compared with 28.3% in the preceding year (2009). On the other hand, as the line graph (right axis) of Figure 4 shows, out of those who sought loans from "family/acquaintance", only 71.6% (2010) could actually borrow money, down by 10 points compared with 81.6% in the preceding year (2009). As

[4] "Survey on Use of Consumer Finance" (Time period of survey: May in each year from 2006 to 2009 and July of 2010) and "Survey on Use of *Yamikin* (Time period of survey: May in each year of 2008 and 2009 and July of 2010). Survey was conducted via the Internet. Subject was general consumers at the age of 20 or older who are registered in a survey institution.

personal income of those who borrowed money from "family/acquaintance" is on a downward trend, it is increasingly likely that an in ability to repay such loans will become a growing social tension in the near future.

3. Illegal Financial Market Now Starting To Expand

The survey data also illustrates the increasing harmful activities of illegal lenders (*Yamikin*). To gauge the extent of harmful impacts on borrowers from *Yamikin* activities, the authors also researched the actual situation of usage of *Yamikin* by borrowers who could not secure loans from legitimate consumer finance companies. Figure 5 shows the trend of the (estimated) number of ongoing users of *Yamikin*. According to Figure 5, it is estimated that the number of people who were using "*Yamikin* Lenders"<u>at the time of research</u> increased from 460,000 (2008) to 580,000 (2010). By reference, it should be noted that the number of *Yamikin* users was estimated to have approximately doubled from about 500,000 right after 2000 when the rate cap was lowered from 40.004% to 29.2%, to about 1 million in 2002, when *Yamikin* activities became widespread nationwide[5]. While significant reductions in *Yamikin* activity were achieved with increased enforcement, MLBL improvements in 2003, and other measures taken during the period before the most recent MLBL amendments, it seems that with the newest amendments in 2006, harmful *Yamikin* activity has started to turn back to the levels of 2002 again, threatening to erase previous gains.

In addition to that, the 2010 survey also focused on the actual specific modes of use of "*Yamikin*" and "Card Encashment[6]"<u>in the past year</u>. It is estimated that 1.6 million people borrowed money from "*Yamikin*" in the past year (2010) and 1.2 million people used "Card Encashment" in the same time period. Furthermore, it is estimated that 2.1 million people have an experience to use "*Yamikin*" or "Card Encashment" in the past year.

Here, there is a gap between the number of users of "*Yamikin*" <u>at the time of research</u> (0.58 million people) and the number of users <u>in the past year</u> (1.6 million people). One of the possible reasons is that people who borrowed money from *Yamikin* might be using it as short-term bridge funding. That is, today, there is a high probability that borrowers are actually using *Yamikin* efficiently, paying very high, indeed illegally high, interest rates, while controlling the total interest charges through the short term nature of the borrowing. And in

[5] Cited from "*Yamikin* Complaint Dial" of Federation of Moneylenders Association of Japan (2002)

[6] False financial practice where a customer buys a product with the shopping line of his/her credit card according to the instruction by a *Yamikin* lender and sells it to this lender to convert it to cash. Also there is a type of practice that appears to be a cash-back offer (refund of cash). It is not necessarily an illegal business.

recent years, we are seeing a growing tendency that *Yamikin* victims don't file a claim.

For example, a *Yamikin* Lender arrested by the Tomigusuku Police Station of Okinawa Prefecture in November 2010 had lent money to at least 400 low-income people, but none of the users consulted with police[7]. Police happened to identify this lender in the process of investigating another *Yamikin* criminal. This incident illustrates the increasingly pervasive nature of *Yamikin* activity. *Yamikin* are developing a sophisticated "business model" wherein they forego some of the traditional heavy-handed collection tactics, and may even limit excessive lending to their "existing customers", but will target new customers whose application to registered lenders was turned down. This "soft *Yamikin*" model has resulted not only in borrowers who have ceased to have a sense of fear of *Yamikin*, but who rather feel gratitude for being able to borrow money and are less aware that they are victims.

In fact, part of the survey conducted by the authors proved the tendency that borrowers are feeling less a sense of inhibition against the use of *Yamikin*, and instead are coming to relying on them. Figure 6 shows the feedback from *Yamikin* users in the past year. According to this figure, only 46.0% (2010) responded that they regret to use *Yamikin*, down from 61.4% (2008). On the other hand, out of those who have accessed *Yamikin*, the ratio of those who actually borrowed money from *Yamikin* was defined as "Borrowing Execution Ratio" and its trend was calculated. According to the line graph (right axis) of Figure 6, the Borrowing Execution Ratio from *Yamikin* increased from 40.3% (2008) to 50.2% (2010). Previously, it was a common behavior that even when borrowers, whose application was turned down by a registered moneylender, approached a *Yamikin*, they tended to hesitate to actually consummate the borrowing, considering the illegality of the borrowing and fear of what would happen if they encountered difficulty in repayment. However, the current survey data indicates that this hesitation on the part of borrowers has significantly decreased. Ironically, since borrowers have been lulled into a sense of "acceptance" for the use of *Yamikin*, the pervasive extent of these criminal networks is growing under the surface of society, with the longer term costs in terms of a decline in public order and the loss of the ability to properly regulate financial activity being kept out of view.

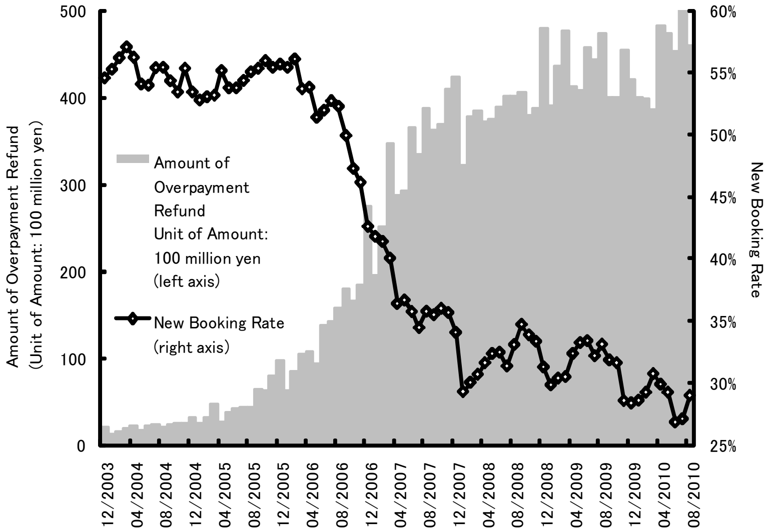
4. Assessment of Revised MLBL

As explained above, the authors could offer a current snapshot of the situation wherein borrowers' behavior with respect to their debt has changed markedly as a side effect of the revised MLBL. These changes will likely only accelerate. Moreover, there is a concern

[7] "*Yamikin* Lenders targeting public benefits" from 'Okinawa Times' (November 23, 2010)

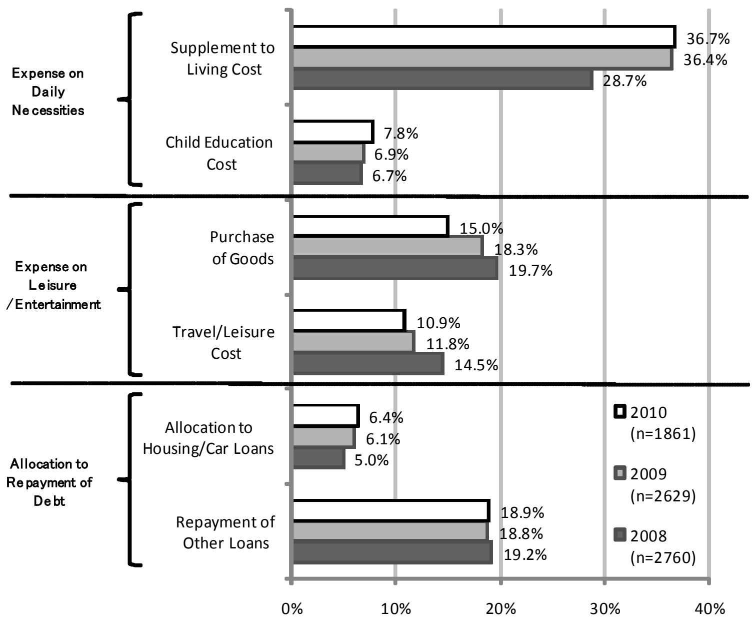
that the so-called "soft *Yamikin*" model, which is increasingly permeating the market for consumer lending below the surface, will financially strengthen criminal and anti-social elements. Given such a reality, it seems the revised MLBL must be urgently reviewed in a drastic manner from a standpoint of protecting borrowers and the broader society.

Figure 1 Amount of overpayment refund (monthly total) paid out by and new booking rate (monthly average) of 7 largest companies dedicated in consumer finance business



Source: "Questionnaire to Lenders". Timing: September 2010. Subject: 7 largest companies dedicated in consumer finance business

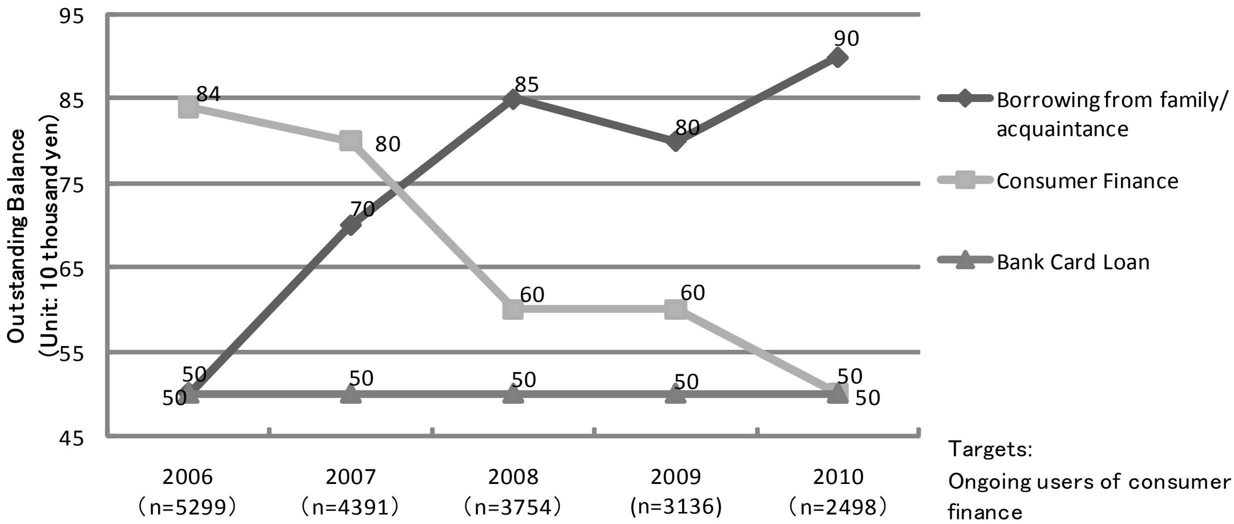
Figure 2 Trend of purpose of applications for consumer finance loans (Multiple answers allowed)



Source: "Survey on use of Consumer Finance" in 2007, 08, 09 and 10

Note: n indicates the number of samples (number of respondents). The unit is "people". The same goes for the following.

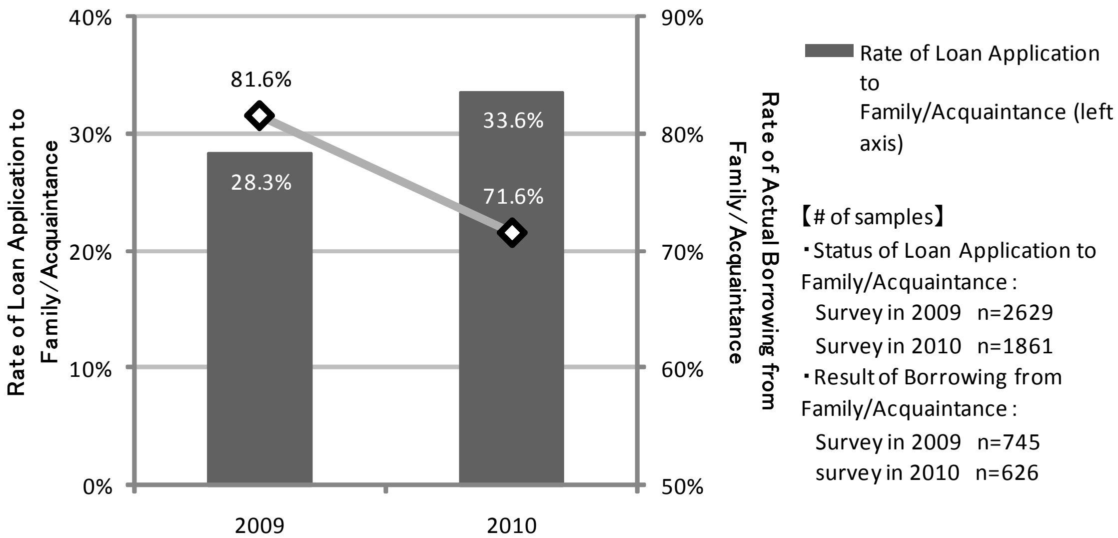
Figure 3 Trend of outstanding balance (median) held by current users of consumer finance



Source: "Survey on use of Consumer Finance" in 2006, 07, 08, 09 and 10

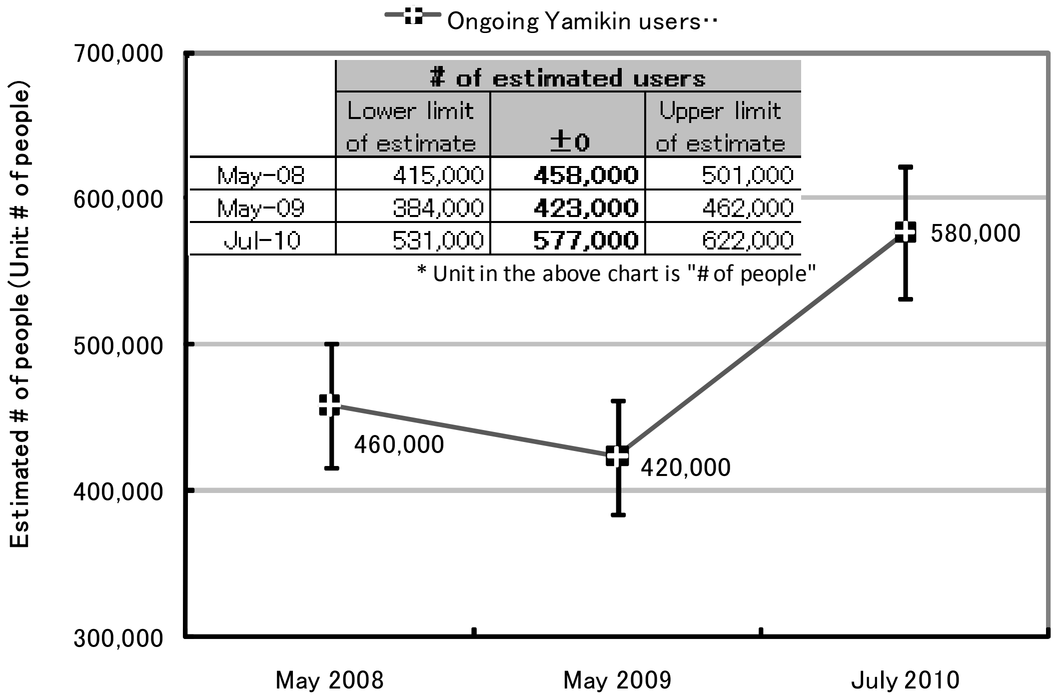
Note: Ongoing usage rate of bank card loan by ongoing consumer finance users is 31.7% (2006), 32.9% (2007), 33.1% (2008), 31.8% (2009) and 34.7% (2010). Similarly, ongoing borrowing rate from family or acquaintance is 21.4% (2006), 24.6% (2007), 20.4% (2008), 22.4% (2009) and 20.2% (2010).

Figure 4 Trend of application for a loan to family/acquaintance and its result



Source: Survey on use of Consumer Finance" in 2006, 07, 08, 09 and 10

Figure 5　Trend of the number of ongoing *Yamikin* users

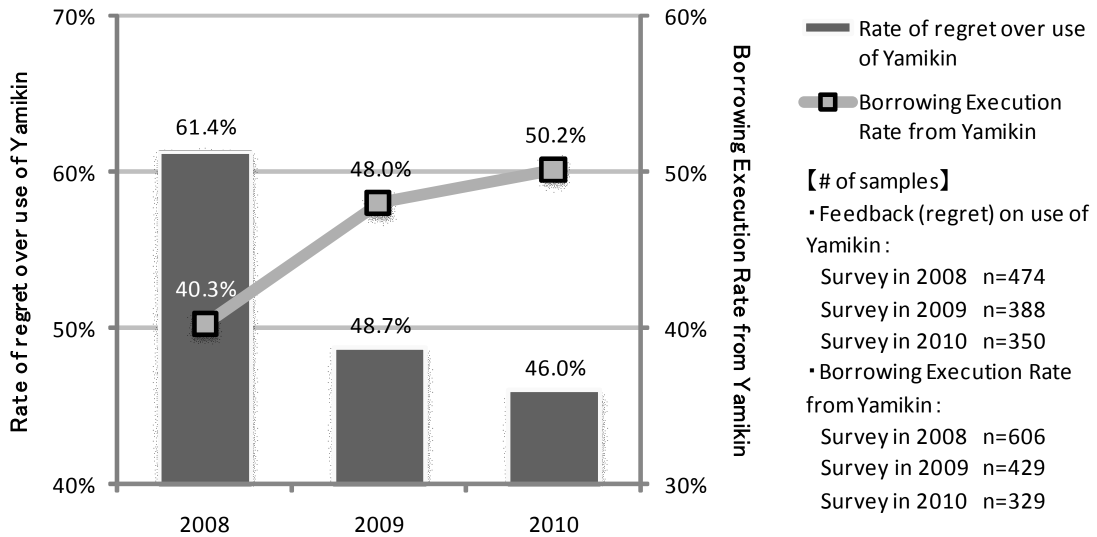


	# of estimated users		
	Lower limit of estimate	±0	Upper limit of estimate
May-08	415,000	**458,000**	501,000
May-09	384,000	**423,000**	462,000
Jul-10	531,000	**577,000**	622,000

Source: “Survey on use of *Yamikin*” in 2008, 09 and 10”

Note: number of samples used for the estimate is 82551 people (2008), 93760 (2009), and 93787(2010).

Figure 6　Feedback (regret) after use of *Yamikin* and trend of Borrowing Execution Rate



Source: Survey on use of Consumer Finance” in 2008, 09 and 10

Note: [Borrowing Execution Rate] = [# of borrowers from *Yamikin*]/[# of those who have accessed *Yamikin*]