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Adverse Effects of the Money Lending Business Law on Owners of Micro-Entities

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Outline:

The Japanese government revised the Money Lending Business Law (hereinafter "MLBL") in December 2006, and imposed on the non-bank market excessive regulations which cannot be seen in other advanced countries. By this law revision, the cap rate was reduced from 29.2% to 15-20% per annum (cap rate reduction). In addition, the Law obliged submission of a withholding tax record, etc. upon screening, and banned in principle lending exceeding one third of an individual annual income (cap amount regulation).

The user base with lower creditworthiness, especially owners of micro-entities, faced a severe credit squeeze. While their demands for short-term unsecured loans have been historically strong, due to such a series of regulation enhancements, moneylenders have increasingly tightened their screening and shut out owners of micro-entities with relatively high risk.

Prior to the revision of the MLBL, there had been demands for loans provided by moneylenders even at a high interest rate of 29.2% per annum at the maximum, which is because unsecured/unguaranteed loans had been provided after a quick screening. In those days, moneylenders had applied the following annual rates in accordance with the terms for customers; 20% or above for unsecured/unguaranteed loans, 15-20% for loans with a guarantor and 15% or below for loans with collateral. Also for business owners in urgent need of encashment, a bill discount had been widely used for lending money on security of the bill, and the annual rates between 4% and 20% had been applied in accordance with the creditworthiness of drawers. Those rates were not too high when compared to other advanced countries.

Generally, owners of micro-entities had borrowed money on security from financial institutions for their mid-and long-term fund needs such as capital investment. Meanwhile, for their emergent short-term fund needs, they used to get unsecured/ unguaranteed loans as bridging loans from moneylenders. In other words, it can be said that lending functions of moneylenders have supplemented banks for such urgent demands of funds that banks couldn’t handle. However, after the revision of the MLBL, the annual cap rate for a loan of 1 million yen and above was defined as 15%, which resulted in forcing owners of micro-entities, whose financing opportunities were narrowed down, to cover opportunity cost or go out of business after failing to get bridging loans.

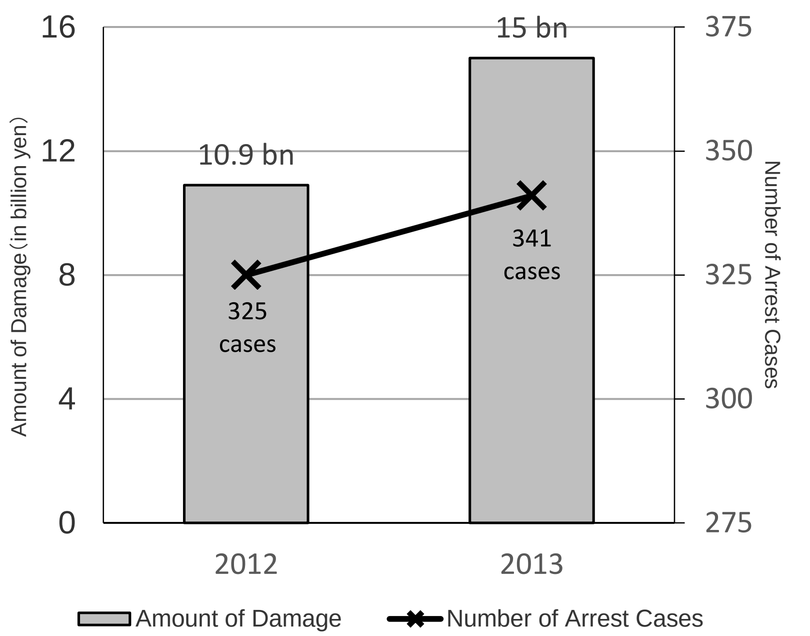
The discussion process in the law revision in 2006 went too hastily, as arguments based on emotion went ahead and the data based scientific validations were utterly stifled. In the future, the government should begin a drastic review of the MLBL from the viewpoint of users by having rational discussions as early as possible.

1. *Yamikin* Victims Started to Increase Suddenly

It was too late for the government to recognize the issue. According to the media, the National Consumer Affairs Center of Japan admitted the fact that *Yamikin* (illegal lenders) victims were increasing in the wake of the MLBL.[1] The similar tendency was also confirmed by the survey released by the Japan Financial Services Association. We recall that newspapers simultaneously reported on April 4, 2013, a year earlier, that *Yamikin* victims were decreasing from the effects of the MLBL, by referring the data released by the National Police Agency.

Thereafter, however, based on the data by the National Police Agency, the number of arrests of *Yamikin* and number of victims started to increase suddenly (Figure 1)[2]. Further, the number of news articles covering *Yamikin* victims is on the increase. Especially, the fact that owners of micro-entities have become victims[3] is prominent, reflecting the reality that owners of micro-entities in financial difficulties are borrowing from *Yamikin*, despite their knowing that *Yamikin* are illegal. In addition, the expansion of *Yamikin* victims is just one of the side effects by the MLBL. What lies beneath is the actual circumstances where the unsecured loan market, especially business loans, has shrunk to the serious level.

Figure 1 Trend of *Yamikin* cases



Source: National Police Agency "Arrests of Life Economy Criminal Offenses in 2013" (March, 2014)

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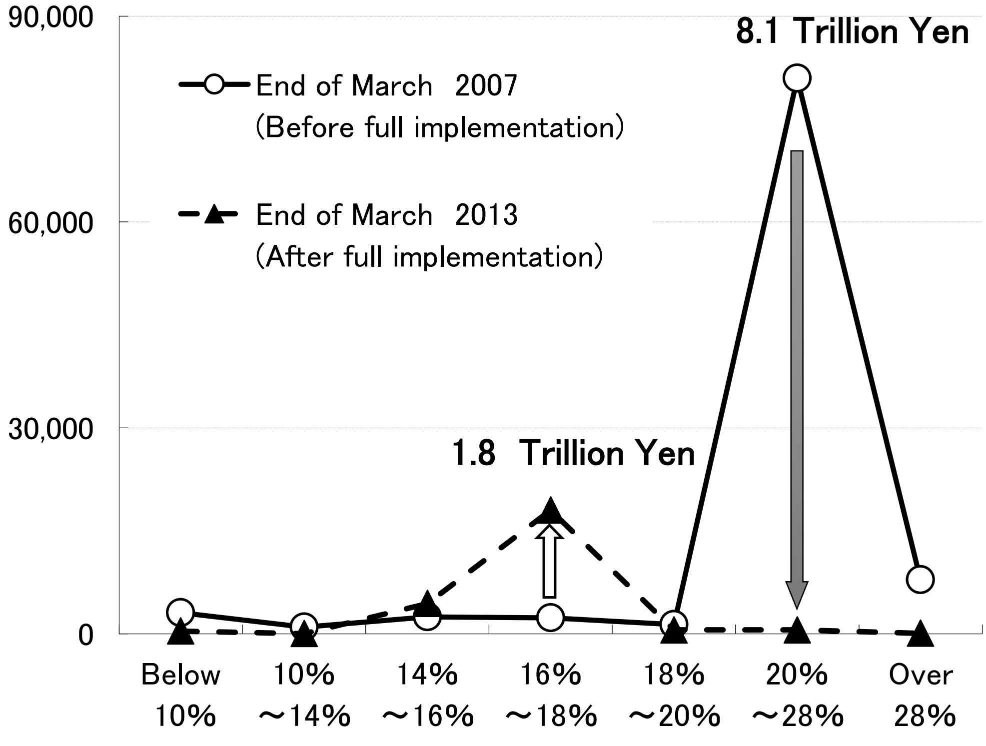
1 e.g. The *Nikkei* (evening paper) on November 13, 2013; "Five 'pawn brokers' were arrested for suspicion of violation of Capital Subscription Law. They provided loans of 400 million yen to 1,200 people."
2 "Arrests of Life Economy Criminal Offenses in 2013" released by National Police Agency
3 e.g. The *Mainichi* on May 15, 2014; "Illegal lending by pretending to be a used-car dealer"

2. Credit Crunch Hit Owners of Micro-Entities

In December 2006, the government revised the MLBL in the name of protecting the so-called “over-indebted persons”. Using the MLBL, the government imposed on the non-bank market excessive regulations which cannot be seen in other advanced countries. Main points of the regulations are: (1) reducing the annual cap rate from 29.2% to 15-20%, (2) obliging submission of a withholding tax record or other documents upon screening and banning in principle lending exceeding one third of an individual annual income (cap amount regulation). Due to such a series of regulation enhancements, moneylenders have increasingly tightened their screening and, by shutting out relatively high risk customers, the consumer loan market has drastically declined. As shown in Figure 2, the peak level of annual interest rates for unsecured loan balance was 20-28% before the revision of the MLBL. However, since contracts at an annual rate of over 20% was prohibited after the revision, the peak interest rate shifted toward lower interest rate range of 16-18%. Yet, due to the simultaneous tightening of their screening, the balance with the peak interest rate was reduced sharply from 8.1 trillion yen to 1.8 trillion yen.

Figure 2 Changes in loan balance of moneylenders of unsecured consumer loans
（Comparison before and after the full implementation）

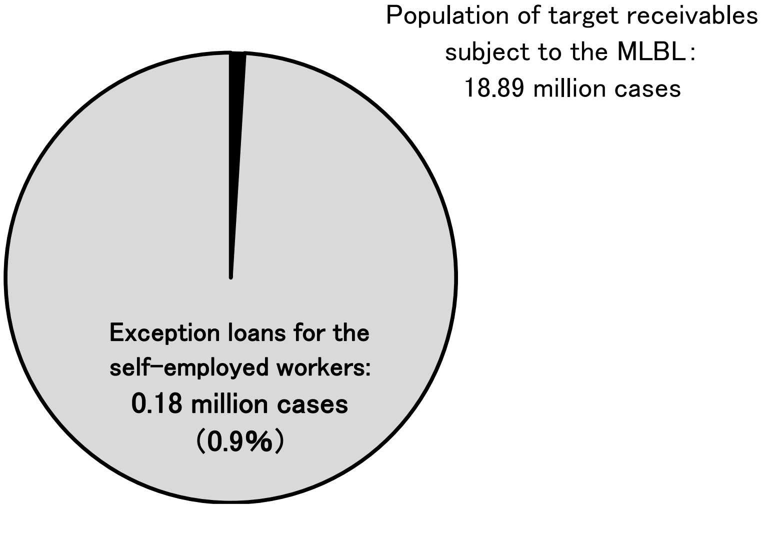


Source: FSA Website, "Statistical Materials related to Money Lending Business”

Further, the loan balance of users did not decrease uniformly in the process of such shift toward lower peak interest rate. Details will be described below, but the user base with lower creditworthiness, especially owners of micro-entities, faced a severe credit squeeze. Capital of many of those companies is vulnerable and, not only their sales are more likely to be limited to long-term clients, but they are more susceptible to economic fluctuations. On those grounds, their demands for short-term unsecured loans have been historically strong. Today, however, it is undeniable that the impact of the MLBL on owners of micro-entities seems to be totally ignored.

In fact, when the MLBL was revised, the Financial Services Agency (FSA) worried about its impact on micro-entity owners who already used moneylenders and established a provision to treat such owners as exceptions, by enforcing certain conditions on lending for the self-employed. Yet, such exceptions were applicable only to the cap amount regulation and the cap interest rate was not allowed to be eased. In addition, for borrowers, preparing documents to meet such conditions is burdensome, whereas screening to check the requirements for the exception is arduous for lenders. At present, therefore, exception loans are rarely applied to the self-employed. As shown in Figure 3, in terms of number of cases, the ratio of exception loans for the self-employed is only 0.9% of the target receivables subject to the MLBL. In addition, when an exception loan is applied to the self-employed, the majority of the cases are real estate loans, whereas unsecured loans are rare. Such reality illustrates clearly that the exception loan for the self-employed has no effectiveness, but rather pie in the sky.

Figure 3 Ratio of Exception loans for the self-employed to target receivables subject to the MLBL

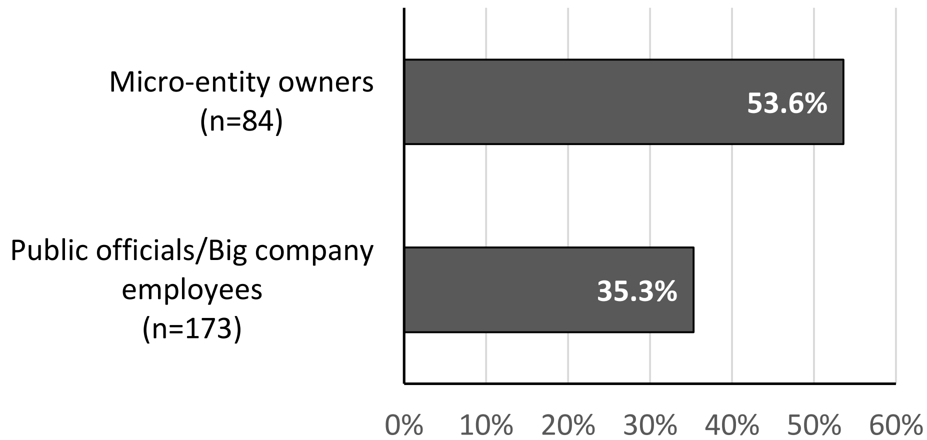


Source : Japan Credit Information Reference Center Corp. (JICC), “Table of changes in debt receivables/registration status by type of transaction” (as of February 2014)

3. “Glass Wall” Called Disparity in Creditworthiness

We conducted a survey[4] to understand the impact of credit crunch on micro-entity owners. First, we extracted[5] “micro-entity owners” as well as “public officials/big company employees” from the samples of persons with experience in using moneylenders. Then, over those two groups we investigated whether they were approved or not, upon their applications for unsecured loans to moneylenders after the full implementation of the MLBL in June, 2010. As Figure 4 shows, the percentages of turn-down of lending by moneylenders were 35.3% for “public officials/big company employees” and 53.6% for “micro-entity owners”, respectively. In other words, around 20 percentage points of difference existed between the two groups.

Figure 4 Ratio of turn-down of loans by moneylenders
（Comparison between “Micro-entity owners” and “Public officials/Big company employees”）



Note："n” in Figure refers to the number of samples (unit: person). Same applies hereafter.
Source：Survey of consumer finance users (January 2013)

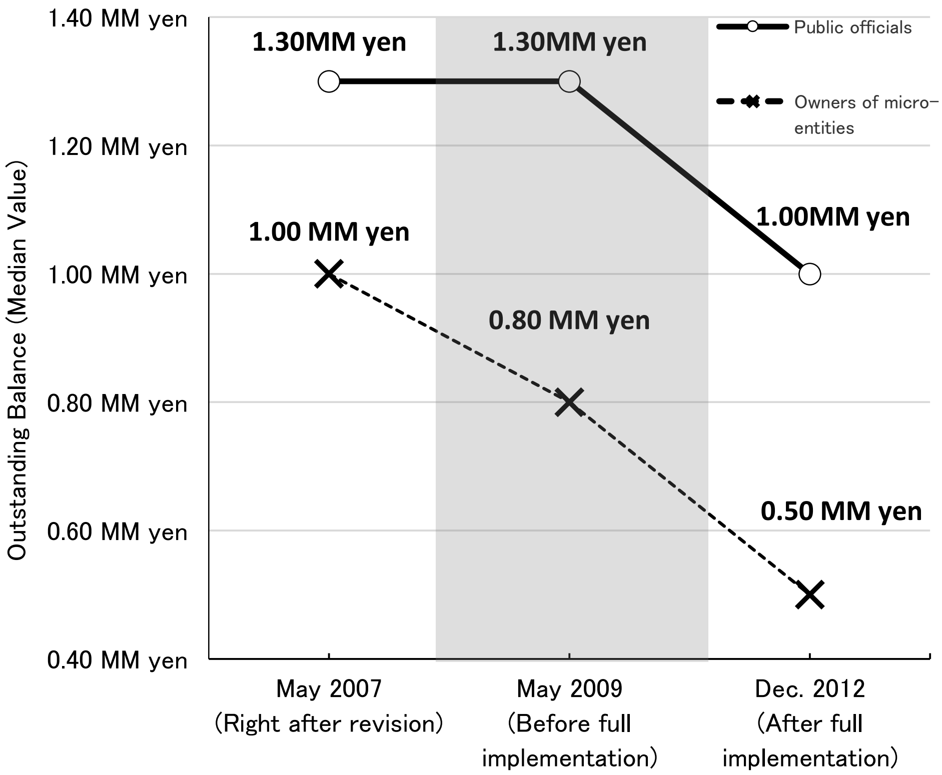
Also, owners of micro-entities were, even though being able to borrow, treated in a disadvantageous manner compared to public officials in terms of credit line as well. Figure 5

[4] Survey body: Hiroshi Domoto, Professor at Tokyo University of Information Sciences,
Osamu Uchida, Associate Professor at Tokyo University of Information Sciences
Survey period: January 2013
Survey method: Survey with questionnaires using the Internet
Survey target: Users of consumer finance and those of *Yamikin* (black-market) lenders were chosen from general consumers aged 20 or over who registered with a survey institution through random sampling to constitute the sample set for the survey target.

[5] Owners of micro-entities mentioned above refers to an individual business owner who employs 5 persons or less, or an owner of a company with a capital of 20 million yen or below; a big company refers to a company having more than 300 employees .

shows trends of outstanding balance of consumer loans (median value) by comparing the layers of “owners of micro-entities” and “public officials”. Outstanding balance for “public officials” dropped just by a small amount of 1.3 million yen immediately after the revision of the Law (May 2007), 1.3 million yen prior to the full implementation (May 2009), and 1 million yen after the full implementation (December 2012). On the other hand, outstanding balance for “owners of micro-entities” shrunk to the half of what it initially used to be as it went from 1 million yen immediately after the revision of the Law to 800,000 yen prior to the full implementation to 500,000 yen after the full implementation.

Figure 5 Trend of outstanding balance of consumer loans per person by occupation (comparison between owners of micro-entities and public officials)



Note: The numbers of samples (number of people) (n) used to tally outstanding balance of consumer loans by occupation are 740 (’07), 596 (’09) and 109 (’12) for owners of micro-entities and 181 (’07), 183 (’09) and 31 (’12) for public officials. Survey specifications for each year is the same as that for January 2013.
Source: Surveys of consumer finance users (in May 2007, May 2009 and Jan 2013)

Essentially, advancement of the consumer credit function should improve cash flows or correct disparity of lives. However, excessive regulations made it more difficult for owners of micro-entities to borrow money and exposed them to negative impact from the revision of the Law. On the other hand, public officials benefited from the revision of the Law as they became able to borrow money at a lower rate than before. Therefore it is highly likely that the revision of the Law in 2006 brought about a marked difference between public officials and owners of micro-entities in the environment of borrowing unsecured/unguaranteed loans and expanded the disparity between these two layers. The fact that credit disparity, or a “Glass Wall” that is difficult to be visualized, has been built between public officials and owners of micro-entities is confirmed undeniably.

4. Economic Meaning of Lending Market

Next, to learn the specifics about the impact of the MLBL that owners of micro-entities received on their business management, I conducted a survey by interviewing 22 consumer finance users in 2009, which was before the full implementation of the MLBL. Through the interview survey, I found two patterns that clearly show how negatively owners of micro-entities were affected when their access to consumer finance loans was cut off. Firstly, there is a pattern corresponding to the cases where an owner of a micro-entity tried to raise funds expeditiously from a moneylender to respond to seasonal demand for funds but caused opportunity cost as their applications to a loan were rejected. The second pattern is represented by a case where a business became insolvent because it could not raise funds urgently from a moneylender.

Generally, owners of micro-entities had borrowed money on security from financial institutions for their mid-and long-term fund needs such as capital investment. Meanwhile, for their urgent needs for short-term funds like the above cases, they used to get unsecured/unguaranteed loans as bridging loans from moneylenders. In reality, the period up to the execution of loans from moneylenders is short despite relatively high interest rates, and also the funding costs are not so high in the case of short-term loans.

Today, in Japan as well, we have finally begun to see academic papers that verified these points at issue. Introduced in Table 1 are some papers that conducted empirical studies on the economic significance of lending functions of moneylenders. TSURUTA (in his paper published in 2005) concluded that flexible lending by moneylenders has contributed to the improvement of fundraising of small and medium-sized companies. UESUGI et al. (in 2011) presented a reality that while smaller companies have more difficulties in financing from banks, these micro-entities have been using moneylenders to mainly get unsecured/ unguaranteed loans. Further, UCHIDA (in 2014) demonstrated the actual situations that moneylenders, as well as banks, place a significance on continuous transaction with borrowers, whereas banks have required careful screening of borrowers to reduce the risk of lending, moneylenders have provided loans upon their speedy screening premised on accepting of a certain level of risk. For banks, in the first place, source of funds for lending are deposits, thus it is a matter of course that they take a cautious stance in lending. Accordingly, it can be said that lending functions of moneylenders have supplemented banks for such urgent demands of funds that banks couldn't handle.

Table 1 Previously-published research that conducted empirical analysis on the economic significance of lending functions of moneylenders in Japan

Title of Paper	**Nonbank Financing and the Moral Hazard of SMEs**	**Overview of Survey on the Actual Status of Financing of Companies after the Revision of the MLBL**	**Comparative Analysis on Screening Methods between Moneylenders and Banks**
Written by:	Daisuke TSURUTA	Iichiro UESUGI et al.	Hirofumi UCHIDA
Year published:	November, 2005	December, 2011	May, 2014
Published by:	National Graduate Institute for Policy Studies	Hitotsubashi University	Graduate School of Business Administration, Kobe University
Outline	Empirical verifications for firms who have used moneylenders, using Company Data provided by the Small and Medium Enterprise Agency.	Analysis of "Survey on the Actual Status of Financing after the Revision of the MLBL" conducted in 2011 (Number of responses: approx. 900 firms).	Comparative analysis on the differences in the screening method for lending between moneylenders and banks based on the results of a questionnaire survey of SMEs.
Conclusion (Summary)	1. The feature of companies borrowing from moneylenders is they cannot borrow from banks despite their urgent need of operating funds. 2. It is concluded that moneylenders are extremely useful for SMEs when they have difficulties in financing or cannot get a loan from banks.	1. Firms borrowing from moneylenders are facing borrowing constraints from banks. 2. Features of companies getting bridging loans are; ・90% of those companies borrowed an amount of 10 million yen or less. ・60% of those companies got loans with a loan period up to 1 year. ・50% of those companies got unsecured/ unguaranteed small amount loans.	1. Banks conduct a more careful screening than moneylenders, while moneylenders focus more on promptness of screening. 2. Banks place more emphasis on soft information (unquantifiable information) on borrowers, such as quality of managers. 3. Moneylenders have provided unsecured/ unguaranteed loans even to the companies whose creditworthiness is not so high.

5. Hearings from Diet members in charge of policy-making at the time of 2006

According to the media[6], currently the Liberal Democratic Party (LDP)'s Policy Research Council has been working toward the revision of the MLBL. As this paper shows, the MLBL has had a big impact on the society and the economy. Especially, the possibility of an adverse effect on owners of micro-entities could have been predicted even in 2006.

[6] e.g. The *Nikke*i (online news) on May 22, 2014; "LDP has started discussions on deregulation of interest rates for moneylenders."

Therefore, to find out how those strict regulations on moneylenders, which was rare even in advanced countries, had been discussed, I conducted hearings in 2014 from the Diet members (as of 2006) responsible for policy-making of the MLBL in the LDP and the Komeito, the then ruling parties at the time of the enactment of the MLBL in 2006. Please note that both names are not disclosed here for fairness as one of those who cooperated with us in this hearing is an incumbent Diet member.

LDP lawmaker in charge (Mr. A):

"In those days, the media reported unilaterally that 'moneylenders are evil', which led to an excessively heated discussion among the public. Further, as some lawmakers within the party seized the opportunity and gave various performances while being aware of public opinion, we were not in the situation of having cool-headed discussions even within the party. Of course, the government was thinking of establishing a special exception system, considering the fund demands of business operators, however we had to put that off, pressured by such fierce opposition within the party. Though we also took into account the re-revision within three years after the revision, the LDP and the Komeito were no longer in power at that time (the regime having been changed to the DPJ) so, the LDP could not take effective steps."

Komeito lawmaker in charge (Mr. B):

"Impact on financing of owners of micro-entities had been a matter of concern since that time. However, we had no choice but to agree on the law revision, unable to take any measures due to the unusual atmosphere of public opinion back then. I recall that when I made a final report on this matter to a leading member of the party who was in charge of policy-making, I was asked by the member, "Here I think the consideration for owners of micro-entities is lacking, but will this really be all right?", and I answered, "I'm also worried about that". Even within the party, there had been many opinions expressing worries about the establishment of the MLBL".

The hearings from the above two (the then Diet members) who engaged as a responsible position for policy-making of the MLBL at that time of 2006 also suggest that they could not take effective measures while having concerns over the impact of the MLBL on owners of micro-entities. From this point of view as well, the current Policy Research Councils of the LDP and the Komeito should work toward the revision of the MLBL by reviewing the political decision-making at the time of 2006 once again, instead of ignoring the impact of the MLBL as a past issue.

6. Summary

Prior to the revision of the MLBL, there had been demands for loans provided by moneylenders even at the high interest rate of 29.2% per annum at the maximum, which is because unsecured/unguaranteed loans have been provided after their quick screening. Especially for owners of micro-entities, whether or not they can get a bridging loan in case of urgent need becomes the lifeblood of their business. In those days, moneylenders had applied the following annual rates in accordance with the terms for customers; 20% or above for unsecured/unguaranteed loans, 15-20% for loans with a guarantor and 15% or below for loans with collateral. Also, for business owners in urgent need of encashment, a bill discount had been widely used for lending money on security of the bill, and the annual rates between 4% and 20% had been applied in accordance with the creditworthiness of drawers. Those rates were not too high when compared to other advanced countries.

However, after the revision of the MLBL, the annual cap rate for a loan of 1 million yen and above was defined as 15%. This forced many moneylenders into going out of their business one after another, which has lessened financing opportunities of micro-entity owners. The law revision in 2006 went too hastily, as arguments based on emotions went ahead and the data-based scientific validations were utterly disregarded. In the future, the government should undertake as soon as possible an objective reassessment of the MLBL that includes the viewpoint of users and offers rational discussion of an issue of critical importance to the Japanese economy.