# Conditions and Possibilities to Promote FinTech in Japan

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## 1. Introduction

The "Labor Market Analysis Report", published by the Health, Labor and Welfare Ministry in January 2015, concluded that the major reason for the recent increase in non-regular workers is that more self-employed workers are closing their businesses and choosing to be employed as non-regular workers. In an article I contributed to an official publication of the governing coalition-member party Komeito (Domoto, 2008), I concluded that the revision of the Money Lending Business Law (MLBL) in 2006 and the subsequent reduction of the annual cap interest rate (from 29.2% to 15-20%) led to a further tightening of credit screening and caused a serious credit crunch, mainly to the self-employed. At that time, more than a few surveys pointed out the correlation between the revision of the law and an increase in bankruptcies of small-to-medium-sized companies (SMEs). For example, Nakamori (2007) pointed out that, based on the survey of Teikoku Data Bank, the revision contributed to an increase in bankruptcies of the self-employed. Furthermore, Tokyo Foundation (2009) reported, based on a survey of SME owners, that smaller sized companies have faced financing difficulties due to the impact of the law revision, regardless of support measures, such as the government's "safety net loan". We cannot place full responsibility for the increase in bankruptcies of the self-employed on the MLBL impact alone, however, we also cannot deny the probability that the law revision accelerated the closing of businesses by SMEs due to financing difficulties.

December 2016 will mark 10 years since the revision of MLBL. The cap rate reduction is still intensifying the rigidity in financing of SMEs. The ratio of business commencements to withdrawals in Japan compare quite unfavorably to those of other advanced countries. One reason is that small lending, such as unsecured and conventional lending, is not functioning. (Reference "An Inconvenient Truth Caused by Cap Interest Rate" for the adverse effects of the cap rate reduction. )

Meanwhile, FinTech has been gaining attention as a new financial instrument. It is now achieving rapid growth in the U.S., and Japan is also moving toward its implementation. In the U.S., there are various business models of FinTech services that have been taking the lead. If these FinTech services are to be utilized as growth strategies in Japan, the urgent task would be to first set up the FinTech market as a provider of unsecured and conventional loans for SMEs.

## 2. FinTech as an alternative to business loan lenders

In an analysis on the SMEs data collected before the revision of the MLBL, Tsuruta (2005) pointed out that business loans from non-banks functioned as a replacement to bank loans, for those who could not borrow from banks urgently. When the MLBL was first revised, banks were expected to take on the function as business loan lenders that provided SMEs with short-term loans. However, since banks come under the strict supervision of regulatory agencies and also act as financial intermediaries by using deposit as a source of lending, they are not appropriate suppliers of high-risk business loans.

Consequently, the idea that is being considered recently is to replace those business loans by non-bank, who virtually disappeared after the revision of the MLBL, with FinTech. Unlike consumer finance lenders, who mainly target individual people, business loan lenders have difficulty standardizing the patterns of borrowers, such as size of business, industry type, and business conditions. Hence, experienced staff conducted face-to-face interviews when providing unsecured or conventional loans. As SME borrowers tend to have high default ratio and need speedy loans, it takes at least 10 years to train credit judgment staff to become experts.

FinTech can act as a new financing service for SMEs that may otherwise have difficulty accessing the financing market. That being said, it is hard to imagine that every FinTech service that suddenly gained power in the U.S. can be applied to our country. In the U.S., the debt behavior of "borrow quickly and repay quickly" enhanced the convenience of the people in financial need. On the other hand, "P2P lending", which supports direct money lending among many unspecified persons, is now being regarded as questionable in the U.S. In May 2016, lending practices by the Lending Club (founded in 2006), a pioneer of this industry which lent money to unqualified borrowers, was questioned. In last December's shooting in San Bernardino, California, in which14 people were killed, it was found that the shooters funded the purchase of weapons such as guns, bullets and explosives through P2P lending. The Japanese media generally reacts sensitively to this kind of crime associated with deregulations; politicians are also susceptible to this type of emotional media coverage.

Therefore, in Japan, FinTech as transaction lending is drawing attention in the moneylending area where general consumers do not get involved in the transaction. In other words, it is regarded as a useful service to statistically analyze and judge cash flow based on transaction history, instead of on the financial data of the borrowing company. Rather than using a Big-Data-based credit judgment model, it would provide the same service as business loan lenders

## 3. Possibility of Transaction Lending

The U.S. company PayPal, which was founded in 1998, is known as success case in the FinTech industry for their highly convenient settlement services. PayPal newly entered the "transaction lending" business in 2013. They provide loans after analyzing their retailer client's transaction history. The loans are short-term business loans, and based on a simplified credit judgment, clients are provided unsecured and conventional loans in a timely manner.. According to the company, this service brings a big advantage to SMEs who are not able to borrow from banks and cannot carry sufficient inventory. Furthermore, Amazon.com, the largest online superstore in the U.S., also provides a similar service to their client companies, which has produced good results.

In the U.S., in the beginning, the main users of the service were those who could not borrow from banks. However, recently, the service has been extending to loan users who prioritize speed and convenience. Expansion of the loan customer base increases the range of loan rate; currently, money loans at a rate of 20% and higher per annum is widely generalized.

In Japan, however, the Interest Rate Restriction Act (the IRRL) that regulates loan rates is an obstacle to promote FinTech. The cap rate under the IRRL is defined as "20% per annum for principal of less than 100 thousand yen; 18% per annum for principal of 100 thousand yen or more but less than 1 million yen; 15% per annum for principal of 1 million yen or more". The cap interest for a loan of 1 million yen for 20 days comes to about 8,000 yen. This is an extremely strict regulation, unparalleled with other advanced countries. There is also a deep-rooted criticism that the IRRL is not fit for current times, as it has not been reviewed since its enactment in 1954. (While the average starting salary of college graduates at that time was 12,000 yen, the current starting salary is 200 thousand yen). In fact, during the discussions over the MLBL, a revision of the IRRL was also being considered. Yoshitake Masuhara, a Lower House member, who at the time was responsible for the law revision in the Liberal Democratic Party, explained the necessity of the revision of the IRRL by saying "the assumption at the time of enactment in 1954 was; loans of less than 100 thousand yen were for individuals, loans of 100 thousand yen or more but less than 1 million yen were for SMEs, and loans of more than 1 million yen were for large companies."[1]

Despite domestic regulations that make it difficult for FinTech services to operate, several cases in the transaction lending field exist. (Table 1). Here are the results of my interviews with companies engaged in transaction lending.

【Precedent: Company A】

- We first focus on the cash flow of the loan applicant companies. Even if their balance sheet has some problems, our company confirms their recent sales results and past transaction history obtained from their transaction data, and provide loans to applicant companies that pass our credit screening. This is similar to the business model of business loan lenders who used to be called "*machikin*", or street financiers.
- Examples of companies with high loan needs are, those newly founded companies, or those with liabilities exceeding assets but with high profitability, etc.
- Though our loan rates are high, we receive loan requests from SMEs who already have loans with main banks. As it takes time even for good-standing SMEs to borrow from main banks, quite a few SMEs prefer to borrow from transaction lending.
- The bad debt ratio of transaction lending is less than 5%. The average borrowing balance is 3.6 million yen. Its convenience is well received, thus, repeat rate is high. However, there was also a case where the borrower fell into insolvency after borrowing several millions of yen. At present, we have been trying to understand what causes financial deterioration by supplementing the data of credit bureaus.
- In our credit screening, we do not place importance on the company's financial results, but instead, examine their recent sales trends and check the company owner's own credit information. Surprisingly, there are many cases where there is a great amount of borrowing balance under the business owner's name. We refuse to provide loans in such cases.
- Interest rate deregulation allows a wider selection of products. At present, the earliest that the loan money can be transferred is a few days after we receive the loan application. However, if interest rate setting can be made more flexible, loans can be transferred within a few minutes on the day of the application through simplified screening. Also, if borrowers can repay on the same day, it would help drive potential need for funds and expand SMEs' business opportunities.

【Precedent － Company B】

[1] The Asahi Shimbun, October 18, 2006

- The need for our loan is higher among smaller businesses than medium-sized businesses. Customers appreciate our loans because it requires less time to extend the loan and we are able to provide bigger loans than consumer finance companies.
- We target all companies that open their stores in the e-commerce mall to ensure that loan applicants are not concentrated in a specific industry. In fact, we receive more applications from companies that were founded recently. Many applications are from SMEs who have no transaction with banks. The purpose of the loan is mainly for short-term business loans.
- Volume zone for loan amount is around 3 million to 4 million yen. There are some risks to transaction lending, as the size of the loans are higher than that of consumer financing companies. This is a high hurdle to us.
- Because there is a need for transaction lending, deregulating the interest rate is thought to be effective in disseminating the service. However, screenings for FinTech lending tends to be lenient, as it is not conducted through face-to-face credit judgment. In addition, even with sophisticated information technology analyzing big data, it has its limits. Screening the business owner him/herself and registering their credit information should be made mandatory.

The cases above indicate the following: (1) Demand for bridge loan is high, (2) Speedy provision of loan is highly appreciated by customers, (3) Need from recently-founded companies is high, (4) Demand for financing is around 3 million to 4 million yen, which is relatively small as a business loan, and (5) It would be effective to use transaction data and credit information of business owner concurrently to improve the screening process. In addition, the expected interest rate deregulation for transaction lending is thought to play an important part in making small business finance taking root in this country. As mentioned earlier, the annual cap interest rate of 15% is applied to loans of 1 million yen and over, including transaction lending. This obviously does not fit to short-term business loans, especially to transaction lending with high demand for bridge loans.

## 4. Utilization of “Sandbox” implemented in the U.K.

To promote FinTech in this country hereafter, deregulation should be enforced as an incentive for new entrants. Raising the interest rate under the IRRL was discussed in 2006 when the MLBL was revised, but it was passed over on the grounds that it goes against the “protection of consumers”. This shows that, at the time of the revision in 2006, the discussion was focused on consumer financing, whereas business lending was rather neglected. Therefore, developing diversity in financing of SMEs, such as raising the cap rate of the IRRL to 20% per annum at least as a special provision, for example by limiting it to transaction lending, should be effective.

At the same time, to prevent excessive lending, inquiring with credit bureaus and registering credit information at the time of screening should be made mandatory. It should also be required to maintain and share credit information not only on the business owner but also on the borrowing company. Furthermore, a system for regulatory authorities to supervise FinTech organizations that utilize special provisions is desired.

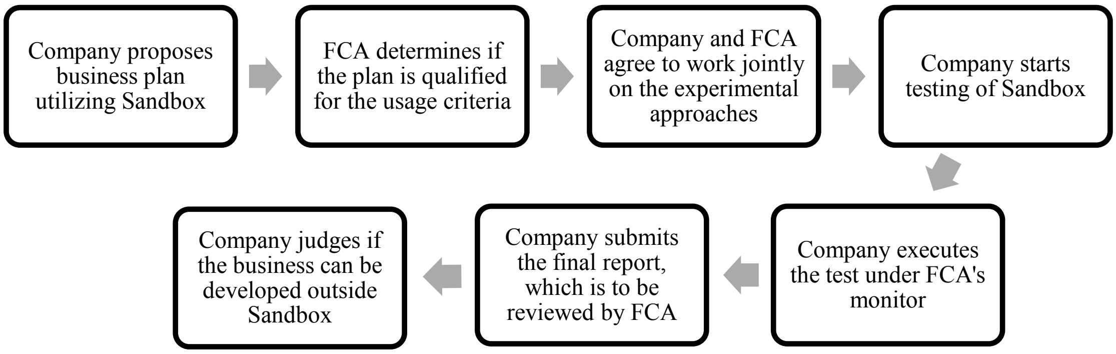
In considering a design for a FinTech system, the U.K. case is a useful example. In the U.K., where the percentage of the financial sector in the economy is high, the government has been implementing regulatory reform in the FinTech field. The U.K. government actively gives advice to companies that intend to make a new entry and has introduced the system of “Sandbox” that allows them to take an experimental approach within a certain range, while ensuring the security of users. The selection criteria for companies to use “Sandbox” are the following: a) It must be a genuine innovation, b) It must serve the interest of consumers, c) Requires experimental enforcement, d) Background research must be conducted. Companies that meet the criteria work closely with the FCA (The Financial Conduct Authority), the responsible regulator, to build a new regulation in line with the FinTech service (Chart-1).

In Japan, deregulation has been promoted in respective municipalities for regional revitalization, and they are showing good results in terms of local promotion. FinTech is a service that covers the whole world and has no geographical borders. Therefore, like Sandbox cases, an effective measure would be to provide a range of validation to FinTech companies, for example by designating certain geographical areas, so that the service can be provided experimentally under a system where a regulatory agency, including municipalities, can monitor the service. Such regional revitalization measures could also encourage FinTech companies to be located in local areas. The Economic Department of Chiba city and the Tokyo University of Information Sciences, to which I belong, have concluded an agreement to work together to vitalize SME’s and attract enterprises. To do so, we have been investigating the special zones strategy for FinTech. In the Diet, a group of multi-party members that are responsible for re-revising the MLBL is also taking steps, such as by holding study meetings. The group should also bring the issue to the national political scene by referring to the cases of local administrations, including Chiba city that have been promoting FinTech.

Table-1　Precedent “Transaction Lending” cases in Japan

| Name of Service | Loan amount (JPY) | Interest (yearly) | Period required for procedure | Term of Repayment |
|---|---|---|---|---|
| Amazon Lending | 0.1～50 million | 8.9%～13.9% | 5 business days at the shortest for the 1st time, 3 business days at the shortest from the 2nd time | 3 months /6 months |
| Rakuten Super Business Loan Express | 0.5～5 million | 8.5%～14.5% | The next business day at the shortest | 1 month - 36 months |
| JNB Store Loan (Yahoo!) | 0.5～10 million | 3.9%～8.2% | The next business day at the shortest | 3 – 6 months |
| GMO Epsilon Transaction Lending * | 0.3～50 million | 3.5%～12.0% | 5 business days at the shortest | 6 months |

Chart-1　Utilization procedure of Sandbox

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**【Reference Material】**

### An Inconvenient Truth caused by the Cap Interest Rate Reduction

The cap interest rate reduction policy is a policy that has adverse effects on society in the long term. In Japan, Prime Minister Abe has been implementing an economic policy, the so-called "Abenomics", since 2013. However, the deflationary economy that has been dragging on for so long continues to undermine the Japanese economy. What lies behind is the slowdown of consumption. The adverse effects of the 2006 MLBL revision, which reduced the cap interest rate, caused a credit crunch mainly to low-income earners. "Abenomics", which raised stock prices, did not benefit people in this class, because not only did it create credit disparity, it also widened disparity in living standards.

Below are the adverse effects of the cap rate regulation on society. Each of the 5 items listed is explained in more detail below.

(1) Applied negative impact on economic growth rate.
(2) Caused the self-employed to close their businesses, and increased non-regular workers.
(3) Increased suicides.
(4) Increased *Yamikin* (or loan shark) users.
(5) Widened disparity in living standards.

First, regarding (1), the MLBL has had an enormous negative impact on the Japanese economy. Professor IWAMOTO and his group at Keio University estimated the impact of the MLBL on Japan's GDP to be negative 8 to negative 18 trillion yen over 6 years. This figure includes the positive economic effect of claims for refund of overpaid interest[2].

Next, regarding (2), the people that were most affected by the credit crunch in the lending market were the small sized SMEs and the self-employed. The "Labor Market Analysis Report", published by the Health, Labor and Welfare Ministry in January 2015, pointed out that the major reason for the recent increase in non-regular workers is that more self-employed workers are closing their businesses and choosing to be employed as non-regular workers.

[2] Prof. Takashi IWAMOTO, et al., October 13, 2013, "The Economic Impacts Simulation concerning 'The Revised MLBL' ", at an Academic Conference on Personal Finance. (The 14th National Conference)

While we cannot blame the increase of business closures of the self-employed on the impact of MLBL alone, we also cannot deny that their financing problems have caused the closure of their businesses. The rigidity in financing of SMEs continues to intensify. One reason that the ratio of business commencements to withdrawals in Japan compare quite unfavorably to that of other advanced countries is that the small lending market, such as unsecured and unguaranteed lending, is not functioning here. The details are described in the body of this article.

(3) is also true. The MLBL was revised in December 2006, and from around the summer of the same year to early 2007, moneylenders tightened their screening criteria. As a result, the contract rate dropped sharply from 60% to 30%. This is also apparent from the IR documents released by the moneylending companies that existed at the time in Japan. Unfortunately, in Japan, the number of suicides reached its peak in 2007. The Japanese government explained that "the MLBL had an effect of reducing the number of suicides" after 2007, when the MLBL was revised. However, this is wrong. The truth is, mirroring the aforementioned trend in bankruptcies of micro-entities, the number of suicides resulting from economic troubles also reached its peak in 2007, when the contract rate dramatically decreased.

Regarding (4), *Yamikin,* there is no statistical data for *Yamikin*. However, around the same time, many incidents that imply an increase in *Yamikin* users occurred, where those in financial need, who can no longer borrow from legitimate lenders, turned to illegal lenders. Many strange occurrences between *Yamikin* and debtors were reported. For example in Hyogo prefecture[3], the media reported that one debtor filed a damage report to the police, claiming that he had been harassed, not by the *Yamikin*, but by several debtors who had borrowed from the same *Yamikin*. Also, in an incident that occurred in Okinawa prefecture[4], a *Yamikin*, who had provided loans to many debtors, was arrested. The authorities later found that the number of this *Yamikin*'s debtors was unusually high during those years. Furthermore, the police investigation revealed that none of the *Yamikin* victims filed a damage report. Not only that, when the police asked the debtors the reason for not filing such reports, they answered, "I feel an obligation to the lender". Yet in another case in Wakayama prefecture[5], a kind, middle-aged

[3] The Kobe Shimbun, May 7, 2010 (evening edition), " 'local *yamikin*' lenders are working behind the scenes: lenders are 'helping debtors' and borrowers are treated as 'king' "

[4] The Okinawa Times, November 23, 2010, " *Yamikin* lenders are targeting public welfare, and receiving repayment without demand of collection"

[5] The Mainichi Shimbun (Osaka), October 28, 2009 (evening edition), " '*Yamikin* lender', who receives repayment without demand of collection, says ' I can't help doing something when I see someone in trouble' "

woman, whose motto is "I can't help but do something when I see someone in trouble", was arrested for operating a *Yamikin*. According to the media coverage, when the MLBL was revised, many people flocked to this kind woman to borrow money from her. This woman was arrested for engaging in the *Yamikin* business, because her debtors gave her souvenirs to express their gratitude upon repaying their debts, and she had actually taken the gifts. These incomprehensible incidents between *Yamikin* and debtors were frequently covered by the news media from around the time the MLBL was revised.

Lastly, regarding (5), when the legitimate lending market could no longer satisfy the financial needs of low-income people, their daily lives became affected. It is well known that the number of households on welfare began to increase about 6 months after the revision of the MLBL (there is a time lag between the application for welfare benefits and the determination on the qualification for benefits). The MLBL also affected the livelihood of low earners who were not on welfare. There are two instances that depict this situation. The issue of rapid increase in low earners, who were unable to pay for school meals, suddenly emerged in Japan in 2007. This indicates that the credit crunch severely affected parents who "wanted to pay for school meals on time even by borrowing money".

Also, in Japan, a person who committed a petty crime, such as a traffic violation, can continue his/her normal daily life without imprisonment, as long as the person pays a fine for that. However, if the person cannot pay the fine, he/she is imposed by *"Roekijyo Ryuchi* "(Detention in a Workhouse in lieu of Payment of Fines) and is assigned light work in prison. In Japan, from 2007, the number of workhouse detainees increased. This is also the result of low-income petty criminals becoming unable to borrow money. This sort of social phenomenon was also reported in a newspaper in Miyazaki prefecture[6], which pointed out the correlation with the revised MLBL. These incidents created the social climate "while those with money to pay for a fine can continue their current life, those without money to pay for it need to go to prison ".

Adverse effects of the cap rate reduction have emerged in various other aspects as well. For instance, the media frequently reported on housewives of low-income households with borrowing difficulties that started working in the adult entertainment businesses[7]. This is also

[6] The Miyazaki Nichinchi Shimbun, September 19, 2011, "Workhouse Detainees are on the increase", etc.
[7] For examples: NHK, November 13, 2010, "Asaichi - 'I can't borrow money any more' ", The TV Asahi, December 17, 2010, "Super J Channel", "Adverse repercussions after the passage of six months from the revised MLBL, 'Tragedy of housewives who resorted to work at adult entertainment businesses and *Yamikin*' ", ZAKZAK, December 2, 2011, " 'Behind the Scenes of Adult Entertainment Businesses', The reason for the increase of housewives working at adult entertainment businesses, interviewed with a beautiful woman working as a call girl in an adult entertainment business (Part 1) ", etc.

one of the adverse effects caused by the MLBL.

However, the people who were forced to change their lifestyles through these adverse effects are mainly those with a low level of education and low income, who live in local areas. The voices of people of this socio-economic class are least likely to be delivered to the government, and tend to be socially ignored.

While the cap rate reduction in December 2006 strictly tightened the regulation and had an impact large enough to virtually extinguish the moneylending industry, legislation for the revision of MLBL passed the Diet in such a short period of time that there was no time to conduct an objective scientific verification. One political reason that such a tight regulation was implemented for the moneylending industry is that the lawmakers expected a rapid expansion of the refund claim market alongside the rapid increase in the number of people with difficulties borrowing due to the cap rate reduction. That is to say, many lawmakers of the Liberal Democratic Party (here after “LDP”) cleverly predicted the advent of new rights and interests, owing to a profit shift from the moneylending industry to the attorneys / judicial scriveners' industry after the law revision. In fact, after the cap rate was reduced from 40.004% to 29.2% in 2000 following the so-called “*Shoko-Loan-Issue*”, many small and medium-sized lenders based in local areas gradually withdrew from the market. Moneylenders in local areas tended to support LDP lawmakers elected by local voters. In fact, it is true that as lenders' withdrew from the market, the influence of the moneylending industry on Diet members dropped considerably in 2006. In any event, even now, 10 years since the law revision, the question remains, whether the cap rate reduction was determined with full consideration for people in financial need.

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