Experimental Study on the Effects of Cap Rate Reduction on Excessive Lending

(Analysis of the 2001 Questionnaire Survey of Consumer Finance Companies)

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1. Introduction

The history of the Interest Rate Restriction Law (IRRL), a civil law, goes back to the former Interest Rate Restriction Law enacted in 1877 (revised in 1898 and then in 1919). The current IRRL (the so-called new IRRL) was enacted in 1954 after the war. Under the IRRL, the limited rates are defined as: a) Where the principal is less than 100,000 yen: 20% per annum; b) Where the principal is 100,000 yen or more but less than 1,000,000 yen: 18% per annum, c) Where the principal is 1,000,000 yen or more: 15% per annum. The interest rate standards and the amount intervals have remained unchanged since the enactment of the new law.

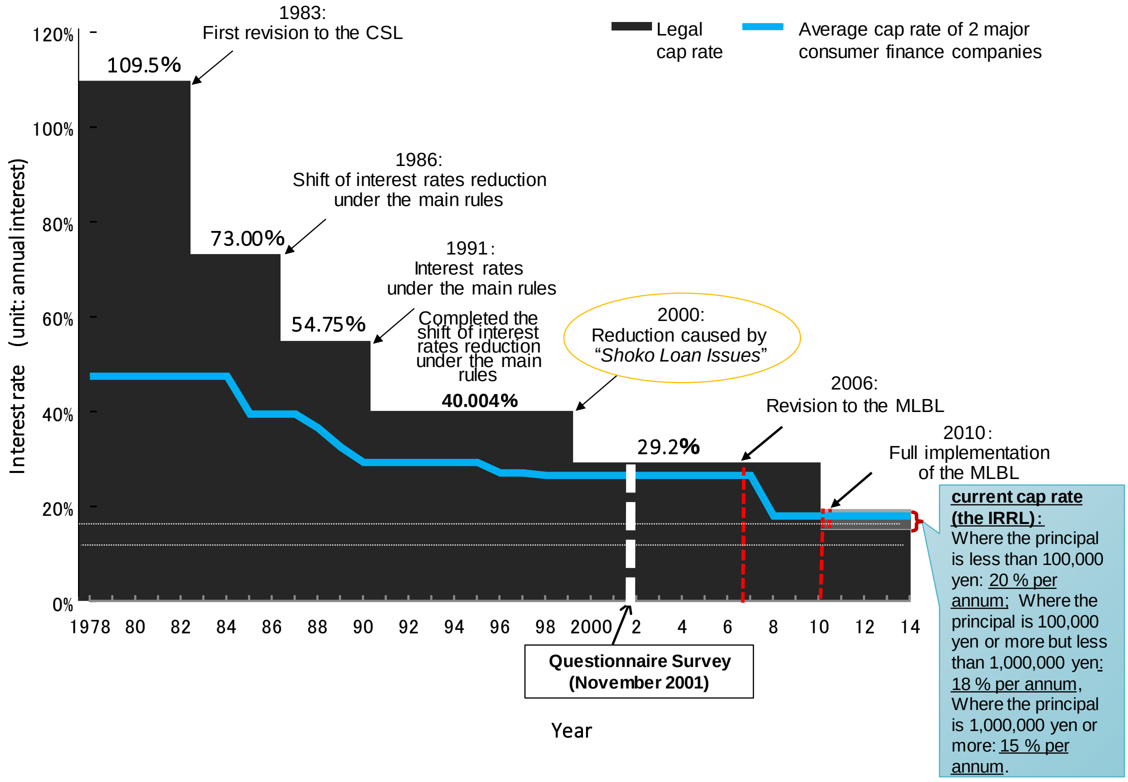
The Capital Subscription Law (CSL), a criminal law regulating interest rate caps for loans, was enacted in 1954. Originally, the IRRL, a civil law, set interest rate caps. However, before the enactment of the CSL, there had been no criminal law that regulated interest rate caps in Japan.

The background behind the enactment of the CSL was the financial market turmoil in the postwar years of recovery. In the decade after the Second World War, there were rampant usurious moneylenders in Japan who collected investments from people by advertising their high yields amid high inflation and they loaned that money to small-to-medium-sized companies (SMEs) at a high-interest rate. However, the government and the Bank of Japan shifted their policies to money-tightening measures after the Korean War in 1953. It caused social issues as represented by the *Hozen Keizaikai Jiken* (an incident involving the Money Preservation Association collecting money from investors), and drove usurious moneylenders into bankruptcy. The government then enacted the CSL to regulate fraudulent moneymaking businesses and usurious moneylenders, and capped the interest rate at 109.5% per annum based on the then actual rate charged by pawnbrokers. By the enactment of the interest rate cap under the CSL, moneylenders who exceeded the cap under the CSL were defined as underground moneylenders, so-called *yamikin*, while those who charged below that rate were defined as legitimate moneylenders. While the contracts on interest rate caps between the IRRL and the CSL are invalid under civil law, the interest rate cap under the

Moneylending Control Law (the so-called former Moneylending Control Law enacted in 1983) was admitted as valid under the "deemed repayment" system. However, this included various twists and turns such as the requirements of voluntary payment and delivery of a certain documents.

Thereafter, during the course of development of the national economy, the main players in financial services for consumers have shifted from pawnbrokers offering " material credit" to consumer finance firms offering "personal credit". In the beginning, consumer finance had been operated by self-employed micro-sized lenders. In the high economic growth period, consumer finance lenders popped up one after the other in the form of corporations. At the same time, amid the rapidly growing industry, excessive lending and harsh collection by some lenders were regarded as problems. As punitive measures, interest rate caps under the CSL were reduced every time these social issues occurred. (Figure 1-1).

Figure 1-1 Comparison and Trends of Interest Rate Caps under the CSL, the Interest Rate Caps (Simple Average) Set by 2 Major Consumer Finance Companies, and the Regulated Interest Rates under the IRRL



Source: Created by the writer based on the Liaison Group of Consumer Finance Companies, "TAPALS *Hakusho* (TAPALS White Paper), 2007" (in March, 2008).

The interest rate cap was first reduced in 1983, which was the time when "sala-kin" (salary men finance) lenders had become social issues due to the spread of consumer financing. At that time, the CSL was revised and the interest rate cap was defined to be 40.004 % (as per the main rules of standard interest rates to be lowered in the future under the Moneylending Control Law). The interest rate cap was first reduced to 73% per annum. As a monetary easing step to prevent the interest rate from suddenly dropping to 40.004% per annum under the main rules, it was stipulated as a supplementary provision that "(The interest rate cap) will be defined promptly by considering economic and monetary environments and moneylending business practices, etc. after the passage of 5 years from the date of law enforcement". Consequently, since that time, the rate was reduced in phases to 54.75 % per annum in 1987 and 40.004 % per annum in 1991.

However, in 1999 the so-called "Shoko Loan Issues" concerning small business loans occurred. This triggered the reduction of the interest rate cap from 40.004 % to 29.2 % per annum after the revision to the CSL in December of the same year. It then went into force in June 2000. Banks at this time were continually reluctant to grant loans to SMEs and tended to revoke SMEs' loan credit. As a result, some rapidly growing "shoko loan lenders" such as Nichiei and Shoko Fund caused social problems with their illicit collection and excessive lending (hereinafter "Shoko Loan Issues"). The revision of the CSL was supposed to address the lenders' acts of collection or their role in the revolving guarantee system. However, the interest rate cap was reduced, due to interest rate and "Shoko Loan Issues". Furthermore, in contrast to 1983 when the revisions were made, the grace period to the full implementation allowed for this time was only half a year (monetary easing steps to avoid drastic change were not taken). This rapid system change caused a great confusion in moneylending, especially the consumer finance industry.

Then in December 2006, the three Laws (the MLBL, the IRRL, the CSL) were revised for the purpose of relieving the so-called "heavily-indebted borrowers"[i] in the consumer finance market. After the full implementation of the IRRL in June 2010, actual interest rate caps set by moneylenders were set in line with the interest rate caps under the IRRL. That is, the deemed repayment was virtually abolished, and the regulated rate interest caps for money loans were identical under both criminal and civil law.

In 2006, it was pointed out that debtors with difficulty repaying increased because heavily-indebted borrowers increased in the consumer finance market. It was a time when economic deflation tendency further worsened and when the effects on the national economy started to become obvious. The average annual income of salaried employees decreased from 4.67 million yen in 1998 at its peak to 4.39 million yen in 2006, showing a deflation tendency [ii]. There were growing financial needs for consumer finance loans to make up for insufficient living expenses. However, while the income deflation trend continued and debtors' annual income gradually went down year by year, debtors had to pay the amount pre-determined at the time of loan contract. As their ability to repay loans worsened over time, debtors whose balances exceeded their repayment capabilities gradually increased, meaning that more people found it difficult to repay their loans.

One reason for the increase in debtors unable to repay loans was a trend towards income deflation, which drove down debtors' ability to pay. It is assumed that the reason for this, given that the interest rate cap was reduced in 2000, was that moneylenders provided excessive lending to a certain customer segment. Under normal conditions, low competitive lenders were supposed to be encouraged to withdraw from the market as the market shrank due to the cap rate reduction. However, the cap rate reduction in 2000 was a sudden system change for the consumer finance industry. Lenders did not have enough time to consider withdrawal from the market, and so moneylenders in fear of their businesses faltering may have more leniently assessed the creditworthiness of a certain customer segment, and then provided excessive lending to secure short-term profits. As a result, while some borrowers were excluded from the market due to the tightening of regulations, the balance of loans to some customers increased. It is thought that this had the effect of temporarily preventing a market contraction. In fact, according to the FSA's business report, the outstanding balance of loans held by unsecured personal loan lenders increased to 11.7403 trillion yen as of the end of March 2006 from 10.6263 trillion yen as of the end of March 2001, showing a 10.5 % increase in 5 years.

In Japan, as a solution to the issues that occurred in the consumer finance market, measures to strengthen economic regulations to fund providers, specifically the cap rate reduction under the CSL, had been taken consistently. On the other hand, monetary counseling, monetary education, and other such relief measures for debt behaviors had not been taken sufficiently for those who sought funds but had little ability to repay. One reason that the monetary counseling functions have not been established institutionally in Japan is because of the Japan-specific structure where attorneys and judicial scriveners monopolize debt workout. For example, when a counselor, who is proficient in providing psychological care concerning money matters, engages in debt workout, such an act is regarded as a legal practice by a non-attorney. On the other hand, since attorneys and judicial scriveners are not professionals in providing counseling, it is difficult to motivate them to provide continuous support to debtors. Because of that, the political situation where the industry was unilaterally punished for the issues occurred in the money loan market had been exacerbated, but discussions over how to change social systems to provide sufficient relief to those with difficulty repaying had been neglected.

In this paper, I noted the changes of credit behaviors by consumer finance companies after the reduction of interest rate caps defined under the CSL in 2000 from 40.004 % to 29.2 % per annum. The source of this analysis was a survey of member companies conducted by JCFA (Japan Consumer Finance Association) in November 2001. I had previously been given the aggregate data from the survey, which I analyzed for this paper. (The individual company names were excluded from the aggregate data provided).

2. Survey Conducted When the CSL Was Revised in 2000

The data provider, JCFA, dissolved in March 2014 due to a reduction in its member companies. A voluntary organization, JCFA had had strict eligibility criteria for its membership since its establishment in the Kansai region in 1969, and it had been recognized as an industry group consisting of sound moneylenders in a moneylending industry, which, at the time, was a mix of legitimate and illegitimate lenders. In the 1990s, when many consumer finance companies such as Sanyo Shinpan and Acom went public, I worked for Japan Associated Finance Co., Ltd. (JAFCO), one of Japan's major domestic investment companies. I remember that one of JAFCO’s requirements for being able to make loans and investments to consumer finance companies was to be a member company of JCFA.

Until the dissolution, JCFA had surveyed member companies and made efforts to disseminate information on the business management environment of member companies. JCFA also called upon NIC [iii], another industry group consisting of consumer finance companies, for cooperation to investigate the effects of the revised CSL on the interest rate cap reduction enforced in June 2000. They jointly surveyed member companies in November 2001. NIC, organized by consumer finance companies in the Kanto region in 1974, consisted of smaller lenders than JCFA’s members. The results of the survey that was conducted by JCFA and NIC in November 2001 were released in the *White Paper on Consumer Finance* published in March 2002.

According to the FSA’s business report, made around the end of March 2001 when the survey was conducted, the number of active moneylenders with outstanding loan balances came to 14,337. 6,029 of these were consumer finance companies (unsecured personal loan lenders), and they carried a total outstanding loan balance 10.6264 trillion yen. The data shows that 23 of these were major lenders with an outstanding loan balance of 50 billion yen or above, and more than 99% of those were reported to be micro, small and medium-sized moneylenders with outstanding loan balances of below 50 billion yen. At that time, JCFA had 106 member companies and NIC had 55 member companies, which means that only some lenders in the consumer finance industry had joined. Thus, the results of the survey of those member companies do not necessarily represent the population structure of the whole industry. However, in light of the fact that the interest rate cap was reduced from 40.004 % to 29.2 % per annum all at once under the CSL revision in 2000; it was deemed worthwhile to conduct an experimental study to investigate the results of the 2001 survey by JCFA and NIC in order to find out what managerial measures were taken by the then lenders and determine the effects on people seeking funds.

In this paper, I did not analyze the results already released in the *White Paper on Consumer Finance* published in March 2002. I instead analyzed the results with a focus on the credit behaviors of consumer finance companies that had conducted business operations by the time of the law revision at a rate range (29.2 % to 40.004 % per annum) which was deemed illegal under the revised CSL. The *White Paper on Consumer Finance* focused on loan size and tried to grasp the actual management status right after the law revision. However, my reading of the white paper led me to believe that analytical work was not conducted sufficiently, even though there were survey questions concerning the effects of credit behavior changes on the market.

The following is the survey's implementation outline that I used for the current analysis (quoted from the white paper).

*** Survey Respondents:**	**A total of 156 member companies of JCFA and NIC**
*** Number of Surveys Collected:**	**95 companies (collection ratio: 60.9 %)**
*** Survey Method:**	**Mail Survey**
*** Survey Period:**	**November 2001**

This survey was intended to grasp the actual management status of member companies at that time and the issues they faced. Although there were only some limited questions available for academic usage, the results shed light on the credit behaviors of consumer finance companies after the cap rate reduction. I hereafter explain the results of my analysis for the competitive situation in the market and the changes in the companies' credit behaviors before and after the cap rate reduction.

3. Survey Analysis Results

3.1 Actual Conditions of the Market Structure from a Viewpoint of Interest of Main Products

Figure 3-1 indicates, as of the end of March 2000, the outstanding balance by interest rates for main products by member companies, as well as the number of lenders by interest rates for those main products. "The outstanding balance of main products by interest rate" is the aggregated amount of loan balances of member companies calculated by the interest rate range of their main products. "The number of lenders of those main products by interest rate" is the aggregate number of lenders calculated by the interest rate range of the main products of each member company.

Firstly, it is noticeable in the figure that the peak values of the outstanding balance and the number of lenders do not overlap. That is, before the interest rate cap was reduced from 40.004% to 29.2%, the highest peak amount of the balance in the market was 2.76 trillion yen at the rate of 27%, and the second highest peak was 1.09 trillion yen at the rate of 25%. On the other hand, the highest peak number of lenders was 23 companies at the rate of 39%, and the second was 21 companies at the rate of 36%.

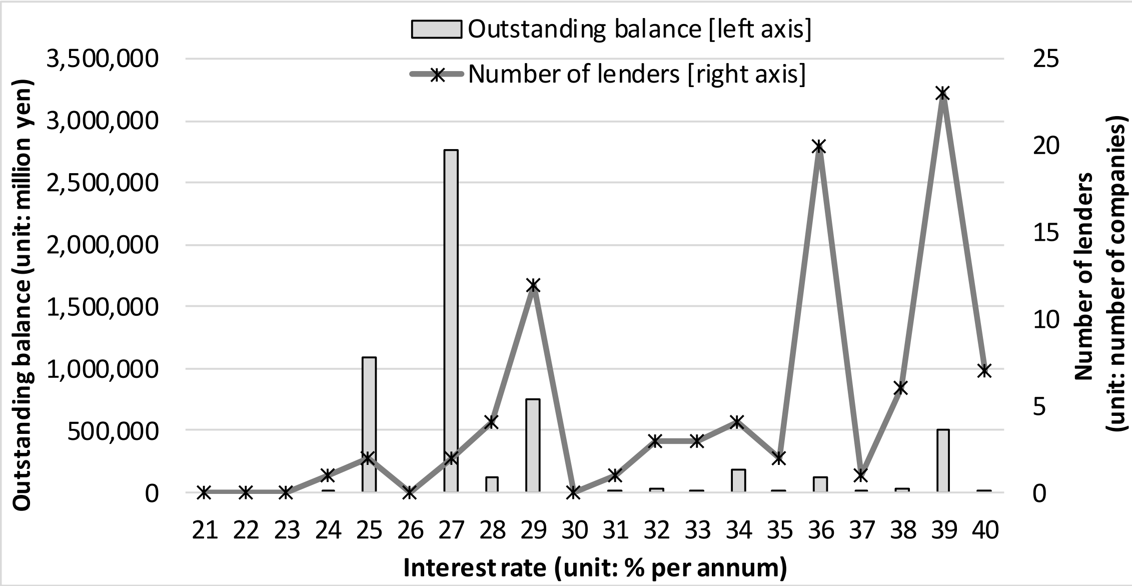
By the time of the cap rate reduction, there was also a change in the abovementioned trends.

Figure 3-2 shows the outstanding balance by interest rate of member companies' main products and the number of lenders by interest rate of those main products as of the end of March 2001. According to this, the highest peak balance was 3.11 trillion yen at 27%, and the second highest was 1.82 trillion yen at the rate of 29%. The peak number of lenders stood out at the rate of 29%, showing a prominent trend.

Next, I compared the changes in the market structure before and after the cap rate reduction by summing the balance by interest rate of the main products and the number of lenders by interest rate of those main products from low rates to high rates. Figure 3-3 indicates the total values of the balances by interest rate of the main products by member companies and of the number of lenders by interest rate of those main products as of the end of March 2000, (both values were summed from low rates to high rates). The total value outstanding balances in this figure shows that the value leaps upward from 1.09 trillion yen to 3.86 trillion yen at the rate of 27%. On the other hand, the total number of lenders in this figure indicates that the accumulated number of lenders at the rate of 27% is five companies, which accounts for only 5.3% of the total outstanding balance of all survey respondents. The total outstanding balance at the rate of 29% is 4.73 trillion yen, which accounts for 84.2% of the total balance for all respondents. This figure also shows that the total number of lenders at the rate of 29% is 21 companies, which accounts for merely 22.6% of the total for all respondents. That is to say, before the cap rate of the CSL was reduced, moneylenders with large balances had operated at the rate range of 20-30% while those with small balances had operated at the rate range of 30-40%.

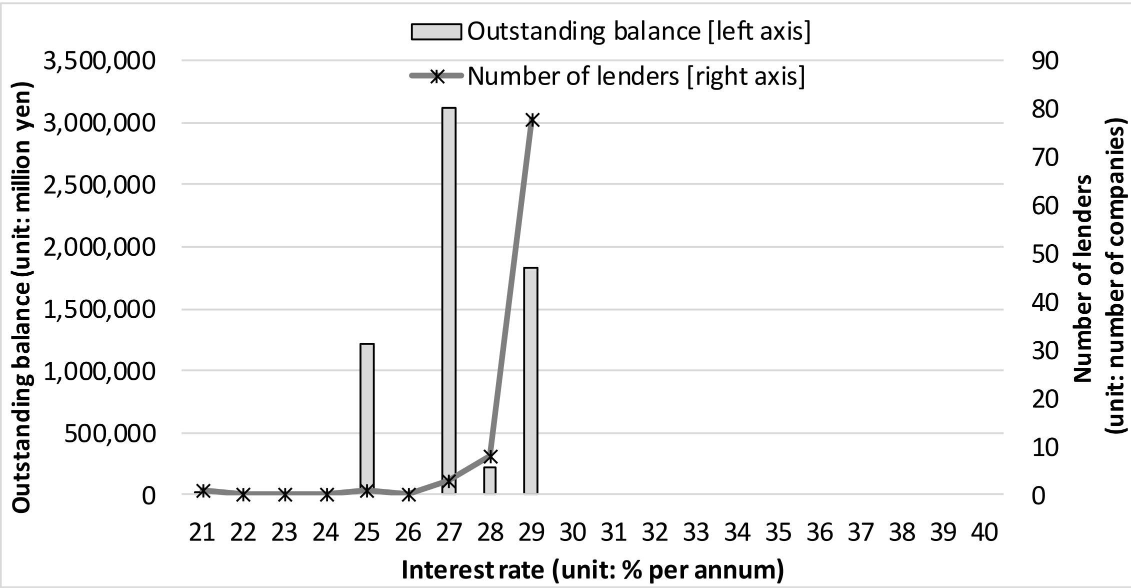
However, such a segregation structure of the market by outstanding balance size became ambiguous after the cap rate of the CSL was reduced to 29.2% per annum. As with Figure 3-3, Figure 3-4 indicates the total values of the balance by interest rate of main products by member companies and that of the number of lenders by interest rate of main products as of the end of March 2001. This figure shows that the total value of the outstanding balance at the rate of 27% leaps upward from 1.22 trillion yen to 4.33 trillion yen. On the other hand, this figure indicates that the accumulated number of lenders at the rate of 27% is five companies, which accounts for only 5.4% of the total for all recipients. This shows a tendency similar to the previous figure. However, most of the lenders who had operated at the interest rate range of 30-40% set up their rate for new products at 29.2%. This means that these lenders ran their business by sticking to the interest rate cap, which made the segregation structure of the market ambiguous.

Figure 3-1　Outstanding Balance by Interest Rate of Main Products by Member Companies　[left axis] & Number of Lenders by Interest Rate of Those Main Products [right axis]　as of the End of March 2000



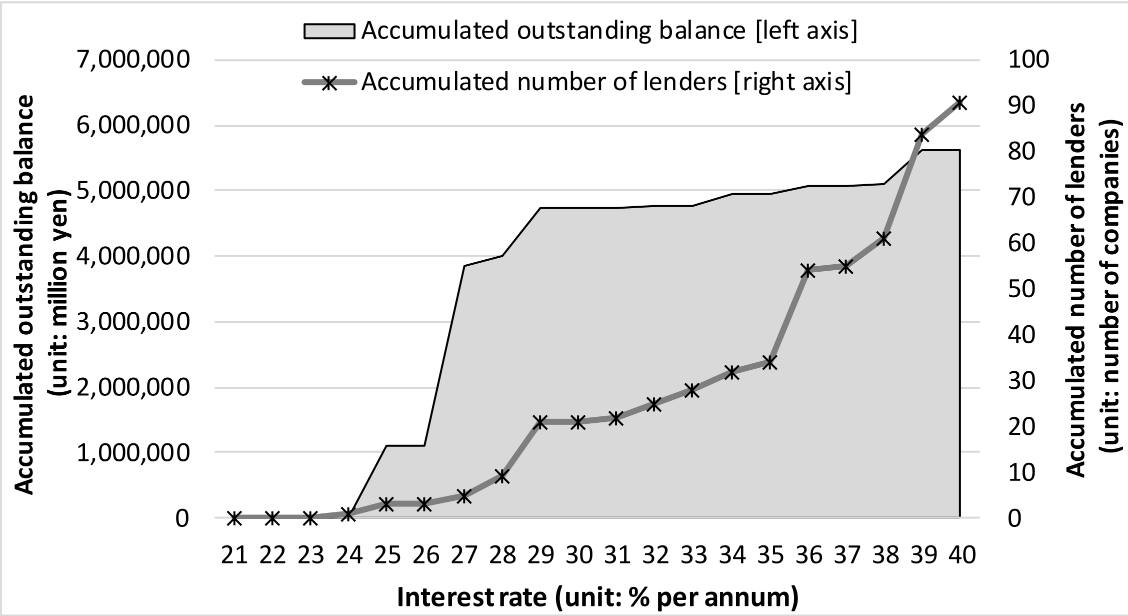
Notes: n (sample size, and the same applies hereafter) = 91 (unit: number of companies)
Source: Created by this writer based on the JCFA survey data

Figure 3-2　Outstanding Balance by Interest Rate of Main Products by Member Companies (left axis) & Number of Lenders by Interest Rate of Those Main Products (right axis) as of the End of March 2001



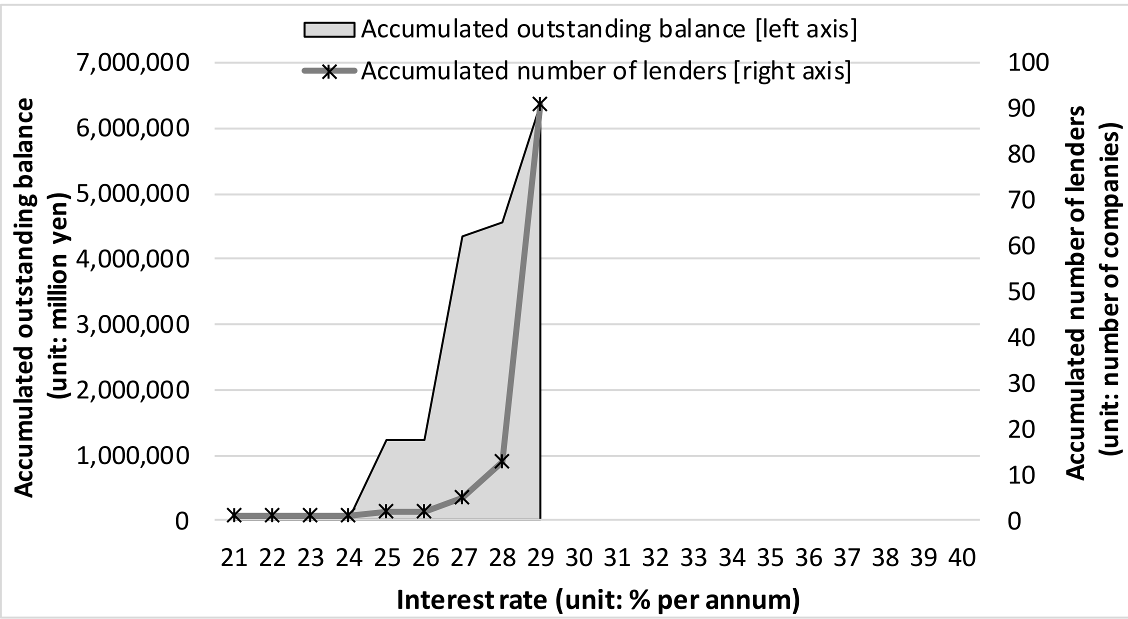
Notes: n = 91(unit: number of companies)
Source: Created by this writer based on the JCFA survey data

Figure 3-3 Accumulated Value of Balance by Interest Rate of Main Products by Member Companies (accumulated from low rate to high rate) [left axis] & Accumulated Number of Lenders by Interest Rate of Those Main Products (accumulated from low rate to high rate) ［right axis］ as of the End of March 2000



Notes: n = 91(unit: number of companies)
Source: Created by this writer based on the JCFA Questionnaire Survey data

Figure 3-4 Accumulated Value of Balance by Interest Rate of Main Products by Member Companies (accumulated from low rate to high rate) [left axis] & Accumulated Number of Lenders by Interest Rate of Those Main Products (accumulated from low rate to high rate) ［right axis］ as of the End of March 2001



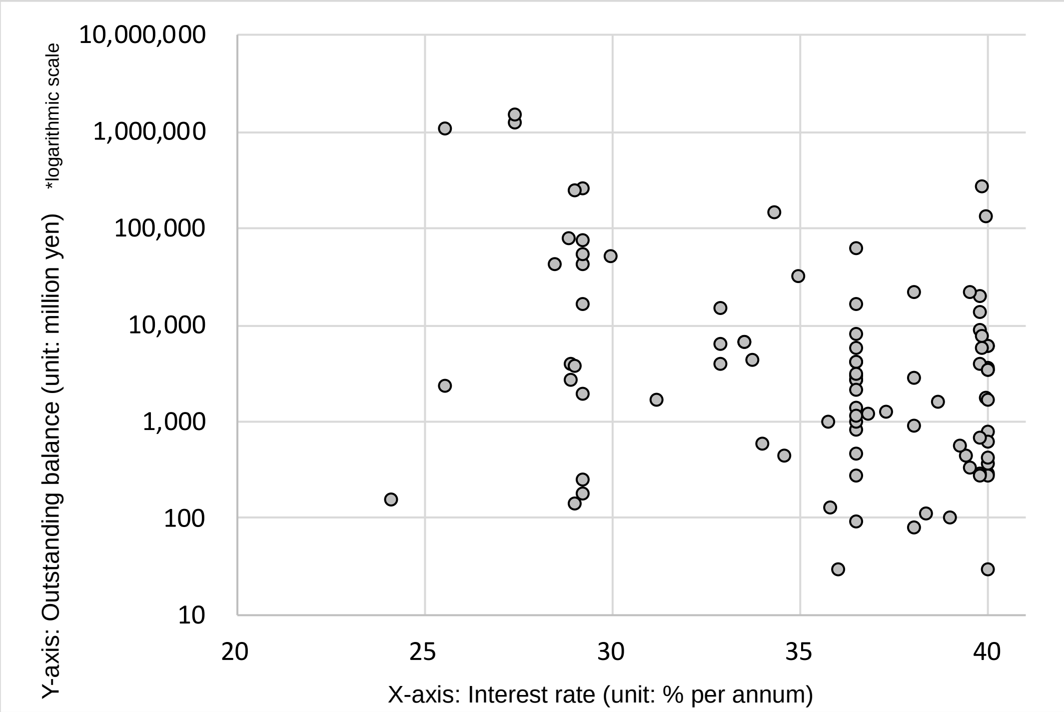
Notes: n = 91 (unit : number of companies)
Source: Created by this writer based on the JCFA Questionnaire Survey data

3.2 Relationship between Interest Rates and Outstanding Balance of Main Products

Figure 3-5 is a scatter diagram showing the relationship between the interest rates and the outstanding balance of main products by member companies as of the end of March 2000. A logarithmic scale indicates outstanding balance on the vertical axis. In addition, I calculated the correlation between the interest rates and the outstanding balance of main products indicated in the said figure, which gave me a correlation coefficient for both variables of -0.3658. The analysis results show a negative correlation between the interest rates and the outstanding balance of main products. This confirmed a certain correlation, though it was rather weak. This shows that, before the CSL cap rate was reduced from 40.004% per annum to 29.2% per annum; there had been a tendency for consumer finance companies with larger size of balances to operate at lower rates, and for those with smaller balances to operate at higher rates.

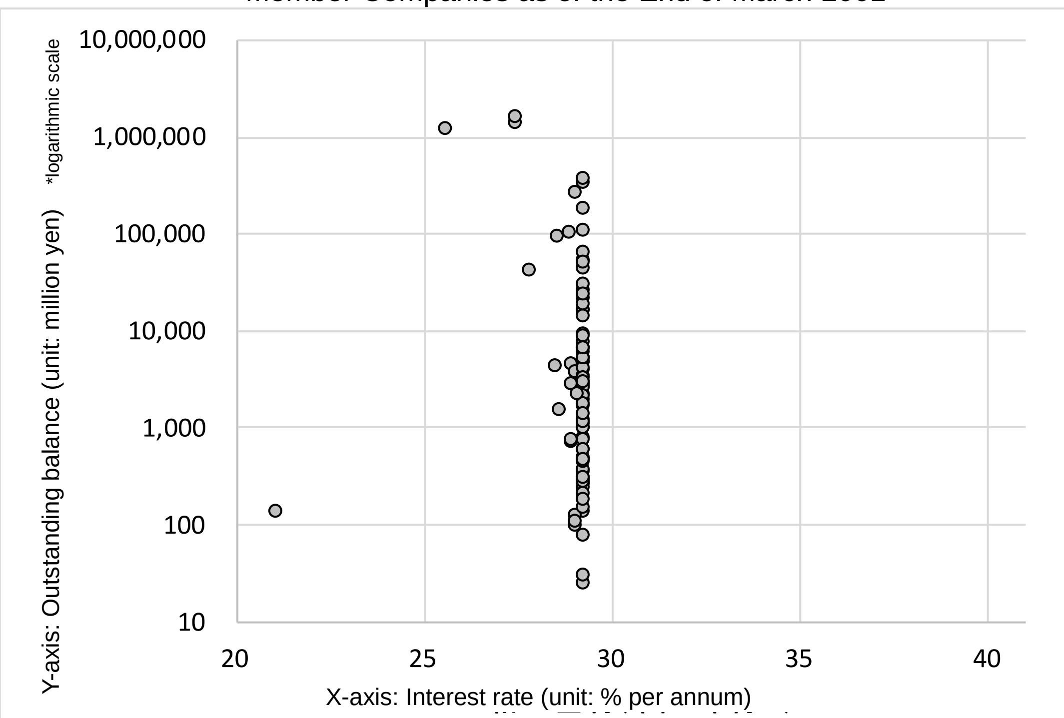
However, this tendency changed after the interest rate cap was reduced. Figure 3-6 is a scatter diagram showing the correlation of the interest rates and the outstanding balance of main products by member companies as of the end of March 2001 (the vertical axis is a logarithmic scale). Calculating the correlation of the interest rates and the outstanding balance of main products in this figure resulted in a correlation coefficient of -0.1118 for both variables, showing that it is not possible to find any correlation between the interest rates and the balances of main products. This means that, after the CSL cap rate was reduced to 29.2% per annum, such a statistical relationship no longer existed between the interest rates of main products and the size of lenders' balances in the consumer finance market.

Figure 3-5　Relationship between Interest Rates and Outstanding Balance of Main Products by Member Companies as of the End of March 2000



Notes: n = 91(unit: number of companies)
Source: Created by this writer based on the JCFA Questionnaire Survey data

Figure 3-6　Relationship between Interest Rates and Balance of Main Products by Member Companies as of the End of March 2001



Notes: n = 91(unit number of companies)
Data: Created by writer based on the JCFA survey data

3.3 Credit Policy after the Cap Rate Reduction

Next, I analyzed the effects of the reduction of the cap rate specified in the CSL on the credit behaviors of consumer finance companies. Figure 3-7 is a scatter diagram showing the interest rate trends for main products by the member companies before the law revision (the end of March, 2000) and after the law revision (the end of March, 2001). The figure indicates that the lenders, all of whom had provided their main products at the higher interest rate range than 29.2% per annum before the law revision (the end of March, 2000), all reduced their rate ranges to around 29% after the law revision (the end of March, 2001). Meanwhile, most of the lenders who had provided their main products at 29.2% or a lower rate per annum before the law revision left the rate unchanged or kept the rate of decline to below 1%, even when they reduced rates. As shown by the 45-degree line diagram in this figure, there was only one lender who raised its interest rate after the law revision.

Thus, since the cap rate specified in the CSL was abruptly reduced as mentioned above, consumer finance companies who had operated at the rate of 30% or higher per annum had no choice but to reduce rates for their main products to the upper limit of 29.2%. On the other hand, for the consumer finance companies who had operated mainly at the rate of 29.2% or below per annum, it is assumed that the effects of the CSL-specified cap rate reduction were relatively small. Consequently, in order to compare the changes in both lenders' credit behaviors before and after the law revision, I analyzed the samples of member lenders by classifying them into two groups:

- **Group A：“Lenders who had provided their main products at the rate of 29.2% or below per annum before the cap rate reduction”**
- **Group B：“Lenders who had provided their main products at the rate of 29.2% or higher per annum before the cap rate reduction”**

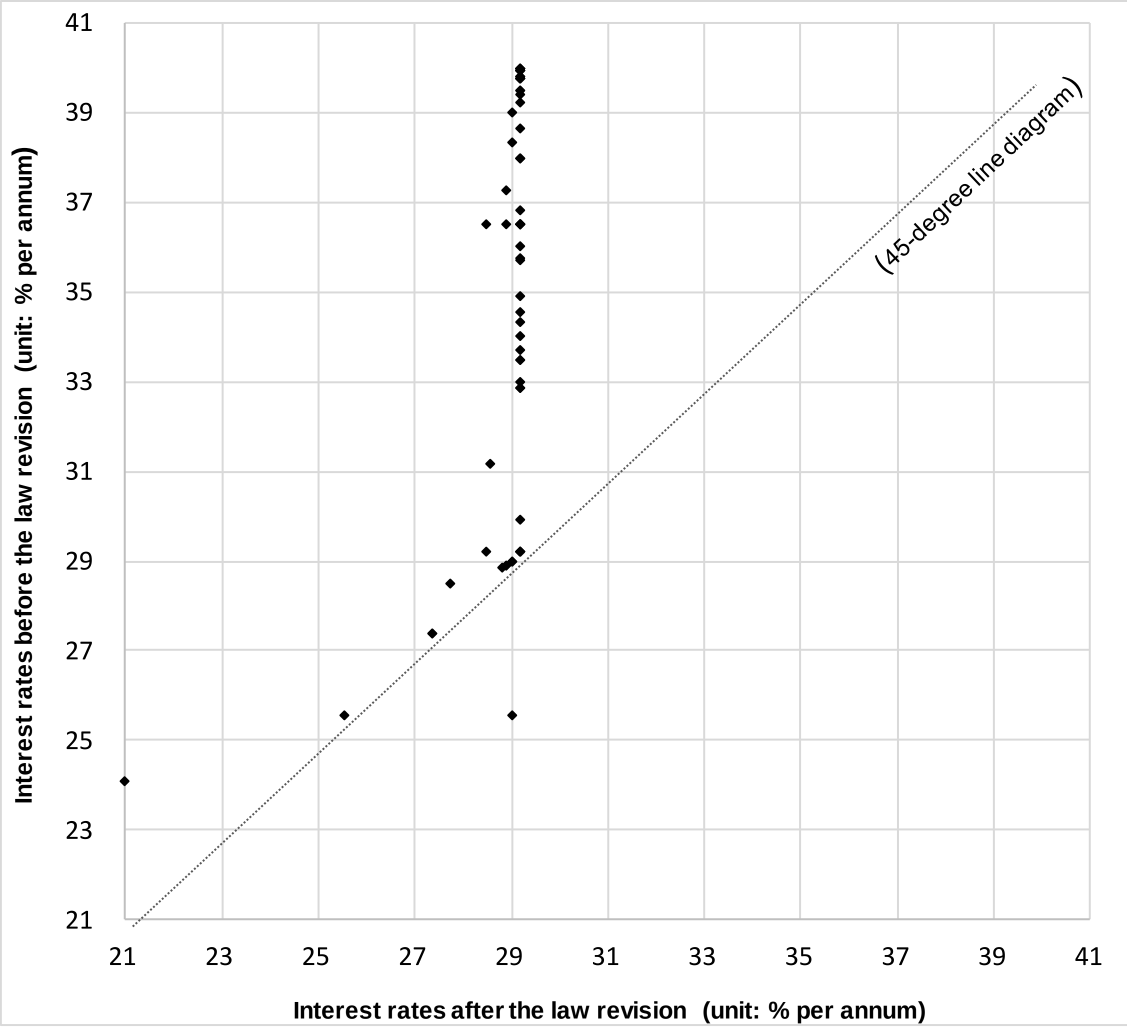
First, I compared the outstanding balances of Group A and Group B lenders before the cap rate reduction (Table 1). According to Table 1, the average of outstanding balances of Group A before the cap rate reduction is 234.2 billion yen. The median is 29.4 billion yen and the standard deviation is 463.8 billion yen, showing that some lenders hold extremely large balances. Meanwhile, the average balances of Group B lenders before the cap rate reduction is 13.2 billion yen, with a median of 2.1 billion yen and standard deviation of 39.4 billion yen. This shows that in contrast with Group A, Group B consists of lenders with small balances. This table indicates the results of analysis, using Welch's t-test, of the difference in balances before the cap rate reduction between Group A and Group B. From that result (P-value＝0.0466), it can be seen that there was a significant difference (significance of 5%) between the outstanding balances of Group A and Group B before the cap rate reduction. That is to say, we can see the following relationship between big lenders and small-and-medium-sized lenders: whereas lenders had operated at the rate of 29.2% or below per annum before the CSL-specified cap rate was reduced from 40.004% per annum to 29.2% per annum, small-and-medium-sized lenders had operated mainly at the rate of 29.2% or higher per annum. This relationship also corresponds with the trend I discussed in section 3.2 of this paper.

Next, I investigated change in management behavior after the cap rate reduction. Figure 3-8 (a) shows the different degrees of impact of the cap rate reduction on business management behavior for Group A and Group B. According to this Figure, among Group A lenders, 41% answered “Not much affected” and 12% answered “Not affected at all”, meaning that the majority of this group answered “Not significantly affected by the cap rate reduction”. On the other hand, among Group B lenders, 81% answered “Very affected” and 17% answered “Slightly affected”, meaning that majority of the lenders answered “Affected by the cap rate reduction”.

Thus, the cap rate reduction had a significant managerial impact on Group B lenders, who had provided their main products at the interest rate range of 30-40% per annum. Figure 3-8 (b) shows survey results regarding their future business policy, including Group A. Concerning the future business policy of Group A, who was slightly affected by the cap rate reduction, the figure shows that 67% answered “Business expansion” and 29% answered “Maintaining the status quo”, showing these lenders' intention to expand their business. On the other hand, as for the responses of Group B, which significantly reduced the interest rates of its main products after the cap rate reduction, 38% answered “Business expansion”, which is higher than the aggregate 14% rate of 11% in “Scaling-down” and 3% in “Withdrawal”. Although not as high as Group A, Group B also demonstrated a trend towards expanding its business.

As we can see from the above, despite the disappearance of the market segment of previous main products due to the tightening of regulations, other data indicates a proactive business attitude among Group B lenders. Via multiple-choice questions, this survey asked about the measures they took after the cap rate reduction. According to the results of the survey, among the measures taken after the cap rate reduction, 12% (n=17 companies) of Group A lenders and 18% (n=60 companies) of Group B lenders answered “Lent money aggressively”, showing a notable difference[i]. The market segment that Group B lenders used to be good at had disappeared due to the cap rate reduction. On the other hand, these lenders tried to expand their business by entering into interest rate ranges around 20% per annum, which is the market segment of Group A. However, Group A lenders not only surpassed Group B in business size, they also had a first-mover advantage in that market where they had targeted a relatively high-credibility customer segment at rate ranges of around 20% per annum. Therefore, the chance of market entry success by Group B lenders should have been extremely low from the beginning.

Figure 3-7 Scatter Diagram of Interest Rates of Main Products by Member Companies Before and After the Law Revision



Notes: n= 91 (unit: number of companies)
Source: Created by this writer based on the JCFA survey data.

Table 1 Comparison of Group A and Group B Lender Loan Balances Before the Cap Rate Reduction

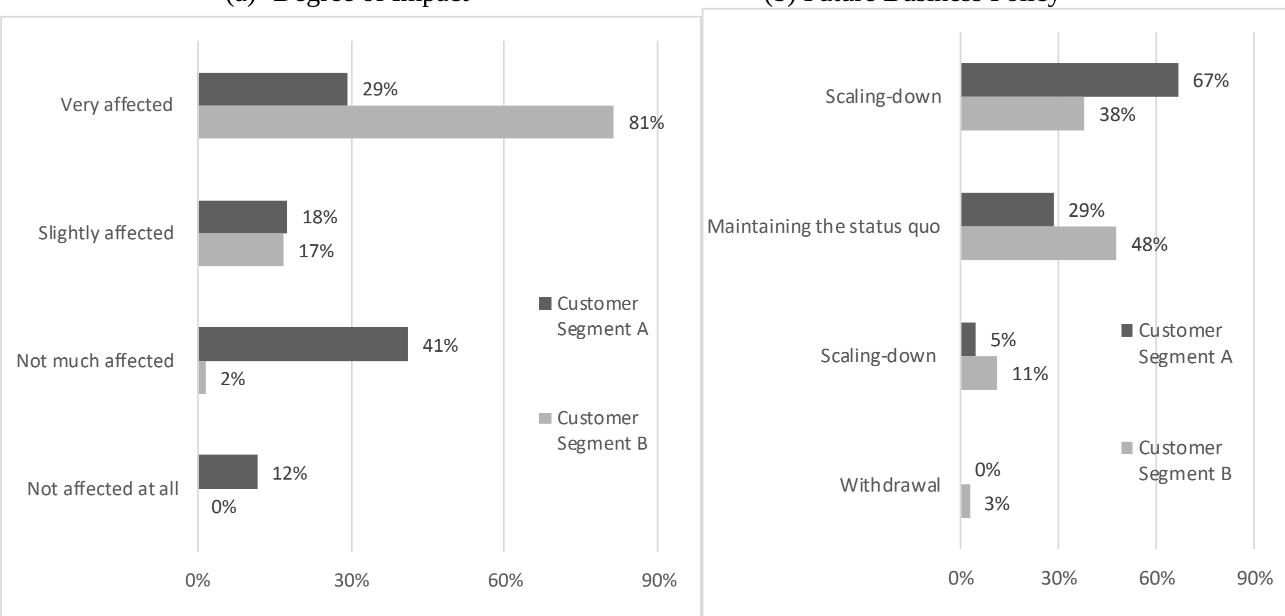
	Group A	Group B
Average	234.2 bn. yen	13.2 bn. yen
Median	29.4 bn. yen	2.1 bn. yen
Standard Deviation	436.8 bn. yen	39.4 bn. yen
Sample Size	20 companies	71 companies
P-Value	0.0466	

Source: Created by this writer based on the JCFA survey data.

These behaviors are not completely representative of standard management decision-making business strategy theory. Generally, as a tightening of regulations causes the market to shrink, low-competitive suppliers are forced to withdraw from the market. However, the cap rate reduction in 2000, triggered by the “Shoko Loan Issues”, was a “complete surprise” to the consumer finance industry. Furthermore, since easing steps to avoid drastic changes were not taken in the cap rate reduction in 2000, the lenders who could not predict the market contraction had no choice but to cope with that situation through stopgap measures in order to maintain their financial conditions for the time being. According to the white paper, at that time, small-and-mid-sized lenders had received investments and loans from major non-banks (e.g. JAFCO, Korakuen Finance Co., Ltd., etc. at that time). However, it seems that those SME lenders had no choice but to hammer out an aggressive business strategy even on a short-term basis because of the possibility that the funds provided by those non-banks could be withdrawn by them if their business plans were weak when presenting IR (Investor Relations) to their investments and loans companies. Consequently, the market became excessively competitive, which may have induced excessive lending.

Figure 3-8 Impacts of the Cap Rate Reduction on Business Management

(a) Degree of Impact (b) Future Business Policy



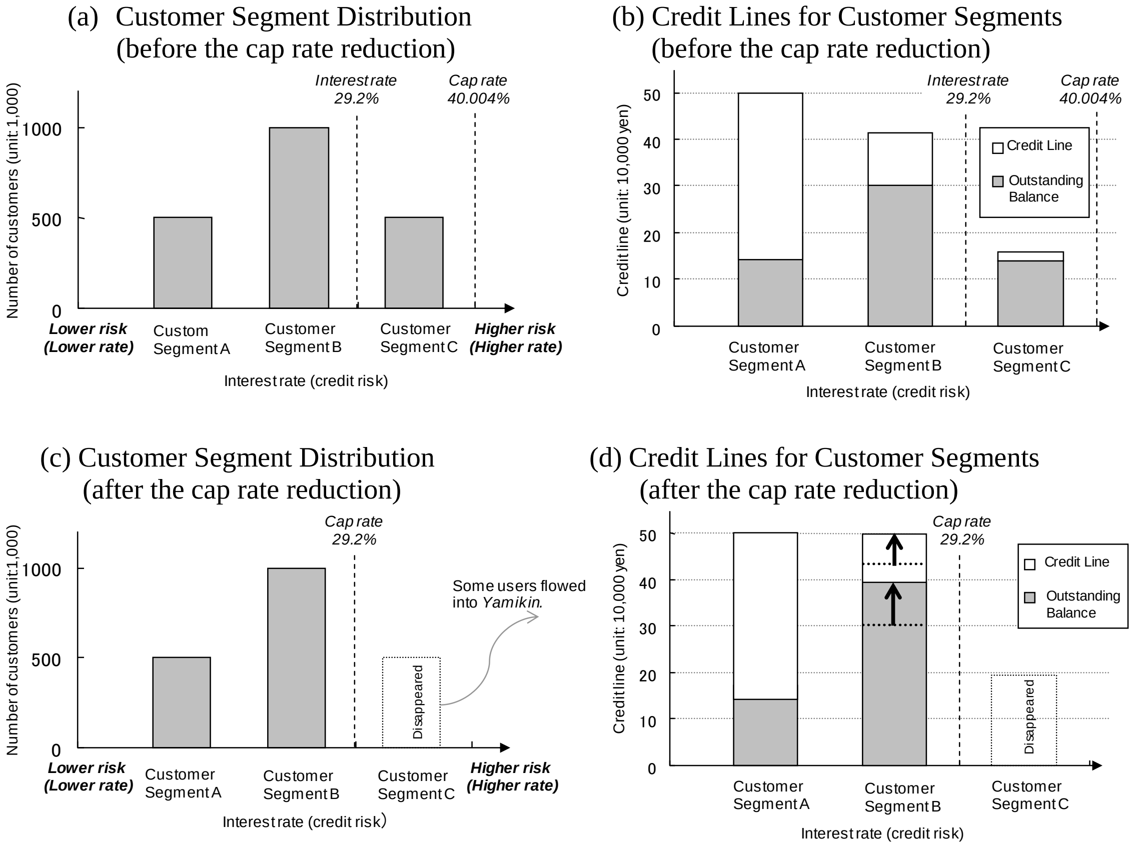
Notes: Group A: n=21, Group B: n=71 (unit: number of companies)
Source: Created by this writer based on the JCFA Questionnaire Survey data.

4. Summary (thoughts on excessive lending having possibly been induced by the cap rate reduction)

As the consequence of the cap rate reduction in June 2000, the credit functions in the consumer finance market started to show distortions around this time. In other words, for some customer segments whose credit lines should have been reduced from the perspective of risk management, lenders’ predilection for trying to secure short-term profits by providing excessive loans instead might have spread to the consumer industry.

Here, to explain the above, I classified the users of the market at that time into 4 groups in order of high creditworthiness (low contractual rate) to low credit worthiness as follows: Customer Segment A (the annual contractual rate: 20-25%), Customer Segment B (25-30%), Customer Segment C (30-35%), and Customer Segment D (35-40%). As Figure 4-1 (a) shows, before the cap rate reduction, major lenders had acquired customers with relatively low creditworthiness, mainly targeting Customer Segment B, and accrued greater balances. At the same time, according to the risk level, those lenders had provided high credit lines to low-risk customers, and low credit lines to high-risk customers[v] (Figure 4-1(b)). Domoto pointed out (in 2006) that, in general, as higher-risk users get less opportunities to borrow in the market, borrowers have a strong tendency to use up to their maximum credit line.

Figure 4-1 Major Lenders' Credit Behaviors Before and After the Cap Rate Reduction (conceptual diagram)

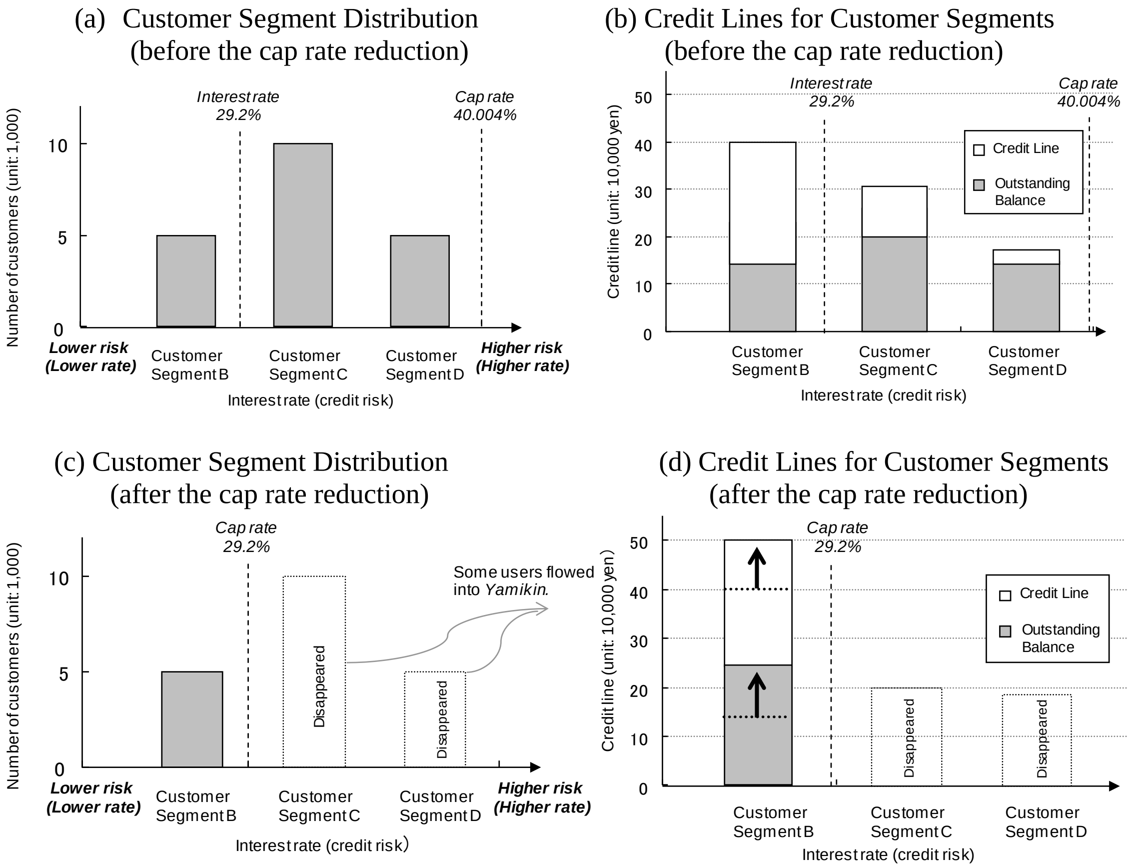


Note: Vertical axis (Number of Customers and Outstanding Balance) data in the figures above are provided as examples.
Source: Created by this writer.

However, as a natural result of the cap rate reduction, major lenders excluded slightly high-risk Customer Segment C with their 30%-34.9% range per annum from their credit screening (Figure 4-1 (c)). At the same time, in order to cover the decrease in revenue due to the disappearance of

Customer Segment C, and because the credit lines for Customer Segment A already reached their limits, they tried to maintain the outstanding balance by expanding credit lines for Customer Segment B.. Unfortunately, when the cap rate was reduced at that time, the labor environment in Japan was continuing to deteriorate, as exemplified by a continued fall in salaried employees' average annual incomes. This prompted Customer Segment B to increase their outstanding balance to nearly the limit of the credit lines (Figure 4-1 (d)). That is, according to the conceptual diagram of Figure 4-1 (d), the credit line for Customer Segment B was 400,000 yen at first, but was raised to 500,000 yen. Customer Segment B increased their outstanding balances from 300,000 yen to 400,000 yen, as dragged by the measures taken by these lenders.

Figure 4-2 Small-and-mid-sized Lenders' Credit Behaviors Before and After the Cap Rate Reduction (conceptual diagram)



Note: Vertical axis (Number of Customers and Outstanding Balance) data in the figures above are provided as examples.
Source: Created by this writer.

Around the same time, small-and-mid-sized lenders, who had operated their businesses at interest rate ranges around 30% per annum also took similar actions. Those SME lenders had run their businesses mainly targeting slightly high-risk Customer Segment C (Figure 4-2 (a)). However, from the perspective of risk management, only the limited credit lines had been given to Customer Segments C and D (Figure 4-2 (b)). As the consequence of the cap rate reduction, it became impossible for those lenders to give credit to Customer Segments C and D (Figure 4-2 (c)). They therefore tried to maintain their revenues by expanding credit lines for Customer Segment B (Figure 4-2 (d)). As this conceptual diagram shows, Customer Segment B, consisting of SMEs, increased their outstanding balances through the measures taken by these lenders.

Amid the continued deflation, both the major and small/mid-sized lenders liberally extended credit to a certain customer segment (here, Customer Segment B), which could have led to an increase of those with difficulty repaying a few years later. In fact, at “The 10th Round-Table Conference on Money-Lending Systems, etc.”, held by the FSA in 2005, the then Director of the Nonbank Financial Companies Office of the FSA’s Supervisory Bureau indicated [vi] that a phenomenon existed whereby lenders, mainly small-and-mid-sized ones, relaxed their credit screening due to the cap rate reduction.

Although competition generally drives down interest rates, it is thought that competition also brings efficiency and stability to the market. However, in recent years, there has been a history in the Japanese consumer finance market of various regulations, including the cap rate reduction, being determined within a short period of time and then subjected to constant improvements. That is, the possibility cannot be denied that this fast-moving system change in the consumer finance market created an atmosphere where lenders adopted a shortsighted business attitude of trying as much as possible to lend excessively to specific loan seekers for the sake of immediate profits, an action that does not always make rational economic sense. Unfortunately, it can be also said that such an atmosphere led to more loan recipients with poor ability to repay in the subsequent consumer finance market in Japan.

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i There is no clear definition for “heavily-indebted borrowers”. For instance, the definition of “heavily-indebted borrowers” between the FSA and the Japan Federation of Bar Associations is different.

ii The National Tax Agency, “Results of the Statistical Survey of Actual Status for Salary in the Private Sector”

iii The official name of NIC is the “Nippon Information Center (NIC)”. The former official name of NIC was the Nippon Information Card Center. However, due to the migration of the function of information exchange centers to credit information bureaus, NIC, the abbreviation name, became the official name of the organization, which activities as a get-together meeting continued.

iv In the analysis of this Survey, non-responses were excluded from the samples.

v In the market before the cap rate reduction, some major lenders large enough to go public had also operated their businesses even at the interest rate range of 29.2 to 40.004% per annum. However, even at the rate range of 30% per annum, those lenders basically had provided credits to the customer segment with relatively high creditworthiness; Customer C, and had not provided credit to Customer Segment D with low creditworthiness. Therefore, the market segment of Customer Segment D is not indicated in Figure 4-1.

vi The report on the results of “Survey of 20 Consumer Finance Companies Who Are Willing to Respond", made by the then official (as exactly what he stated) at the 10th "Round-Table Conference on Money-Lending System, etc." established in the FSA (on February 15, 2005), was highly suggestive. In that report, he stated that, as responses to the cap rate reduction in 2000, "Some small and mid-sized (money) lenders tightened their credit standards, while at the same time, we also found some lenders relaxed their credit standards and expanded their outstanding balances".