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New Challenges after the Amendment of 3 Money Lending Related Laws
--Close monitoring needed on loan sharks and impact on very small businesses—

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Sharp Decrease in High Risk Lending

In December 2006, the 3 money lending related laws, namely the Money Lending Business Law, Interest Rate Restriction Law and the Investment Control Law passed the Diet as a way to deal with over-indebtedness. By 2010 at the latest, the maximum interest rate will be lowered from 29.2% to 20%. Money lenders have tightened their credit standards in anticipation of this change and, as a result, loans to high risk borrowers in particular dropped significantly. Figure 1 shows the amount of outstanding loans as of the end of each month and loan approval rates for each month by seven major consumer finance companies.[i] Outstanding loans and approval rates remained flat until they started to take a sudden dive since the 3 money lending related laws passed the Diet. Because of tighter credit reviews, loan approval rates have fallen from around 55% to around 30% and outstanding loans from 8.5 trillion yen to 6.4 trillion yen.

Reality Presented by Results of Survey

(1) Bank card loans and loans from relatives have risen sharply

In order to capture the consumer finance market suffering from credit shrinking from the perspective of borrowers, my study group conducted user surveys in May 2008 and May 2007.[ii] This article compares and analyses the two survey results and reports the attributes of consumer finance users and preliminary figures[1] concerning their financing activities.

The survey includes questions on loan balance, household accounts, etc., of

[1] Figures and survey results are subject to change as we conduct a more detailed analysis.

current users of consumer finance. As we look at the survey results of 2008 and 2007, the average individual annual income of current users increased from 3.97 million yen (n=3873)[2] in 2007 to 4.35 million yen (n=3349) in 2008. Similarly, their household annual income also rose from 5.83 million yen (n=4390) to 6.56 million yen (n=3709). Further, their savings increased from 1.26 million yen (n=4349) to 3.17 million yen (n=3703). Our analysis is that increase of the individual annual income, household annual income and savings of the users compared to the previous year is the result of tighter credit reviews due to the legal amendments which led to exclusion of high risk users from the market.

The trend evident from the average balance of loans taken out by consumer finance users demonstrates a similar phenomenon. Figure 2 shows the percentage of consumer finance users borrowing from other sources (2008) and the average loan balance of such users (2007 and 2008). You can see from Figure 2 that the average balance of loans from consumer finance companies dropped from 1.16 million yen to 1 million yen. Also, the average balance of cash advances provided by credit card companies, which are also subject to lending caps in the same way as consumer finance loans, decreased from 0.89 million yen to 0.83 million yen. Further, outstanding housing loans dropped from 22.32 million yen to 19.7 million yen in over just one year.

In contrast, bank card loans and borrowings from relatives and friends grew over the one year. Outstanding borrowing from relatives and friends, in particular, surged from 1.84 million yen to 2.01 million yen.

(2) Some go to loan sharks when financing rejected

When we conducted the survey, we extracted persons who applied for consumer finance loans during the past one year but "were unable to receive the financing they wished for" and asked the purpose of the loan and how they coped after the rejection. As a result, we found that users take different actions depending on whether they were seeking loans to cover necessary expenses or leisure expenses. Figure 3 illustrates what those who "were unable to receive the financing they wished for" did after their loans were rejected. You can see that where the purpose of the loan was to cover medical fees or business funds, which are necessary expenses, more users tend to borrow from relatives and friends or loan sharks. On the other hand, where the purpose of the loan was to cover leisure expenses for travel and purchases, a large percentage of the users simply gave up their leisure or purchases. When there is a need to finance necessary expenses that cannot be simply given up, users who were not able to obtain loans from

[2] "n" stands for number of samples (number of responses); hereinafter the same.

consumer finance companies due to reduced credit have turned to their relatives and friends or loan sharks as an alternative source of funds.

We also asked whether users contacted loan sharks. Figure 4 compares the percentage of applicants of consumer finance loans in 2007 and 2008 who contacted[3] loan sharks in the past one year, depending on availability of loans. The percentage of those who contacted loan sharks grew between 2007 and 2008 from 26% to 32% for those who were rejected the loan, from 27% to 34% for those who were unable to obtain the loan in the full amount they asked for and from 42% to 54% for those who were required a guarantor or collateral. Recently, we see more news reports[4] on the increased number of loan shark victims including over-indebted borrowers. Our survey results only evidence the reality that loan shark victims are undoubtedly increasing as credit continue to shrink at a fast pace. In the past, I have pointed out the mental imbalance of those who contact loan sharks[5]. However, it appears that more borrowers have no choice but to contact loan sharks out of necessity.

(3) Cash position of very small, small and medium sized businesses deteriorates

The legal amendments had a negative impact on the commercial finance sector as well. We are seeing more press reports about the sharp rise of failure of very small, small and medium sized businesses due to worsened cash position.[6] My study group conducted another survey to find out the actual use of money lending services by very small businesses.[iii] Figure 5 illustrates the different sources of financing, for "ordinary fund" and "stopgap fund," by very small businesses with 5 or less employees who obtained financing during the past year. You will see that the major source of financing for ordinary fund is bank (39%), consumer finance and credit cards (34%) and relatives and friends (25%). Major source of financing for stopgap fund is consumer finance and credit cards (45%), relatives and friends (31%) and bank (24%).

These results demonstrate that consumer finance and credit cards are widely used by very small businesses with 5 or less employees for both ordinary fund and stopgap fund. They probably use consumer finance or credit card financing because they run a business with only a few members and are unable to

[3] "Those who contacted loans sharks" also include those who contacted loans sharks but did not actually borrow from loan sharks.

[4] For example, "Number of Cases for Consultations on Over-indebtedness in the Last Fiscal Year Hit Record High at 3542, Due to Sharp Increase of Loan Sharks," *Mainichi Shimbun* (Chiba), June 20, 2008; etc.

[5] Hiroshi Domoto, "Analysis of Behaviors of Consumer Loan Users," *Monthly RBA* (October, 2007), Regional Banks Association of Japan

[6] Number of corporate failures in FY2007 was highest since FY2001 when comparable data started being collected (Teikoku Databank)

spend their resource on loan paperwork, and hence prefer the flexibility despite higher interest rates.

It is said that very small business owners are most severely faced with the reluctance by moneylenders to provide financing. Our user survey clearly shows that it is a reality. As such, it is easy to imagine that more very small businesses are suffering from deterioration of cash position due to reduced credit combined with the surge of raw material costs and are becoming insolvent.

Analyzing impact of credit shrinkage will be necessary

The Interest Rate Restriction Law originally included a defect that would cause credit shrinkage in a way totally irrelevant from credit risk. Under the Interest Rate Restriction Law, the interest cap for a "loan in the amount of 100,000 yen or more but less than 1 million yen" is 18%, which means that in case of a 300,000 yen loan, the moneylender does not make any profit unless the borrower maintains the loan for 4 days or longer. Figure 6(a) illustrates the relationship between interest income and cost for a 300,000 yen loan at 18% interest rate in four different loan periods (A: 1 day; B: 2 days; C: 4 days; D: 6 days). Lending may be made in the cases of C and D as interest income exceeds the cost, but loans will not be extended in the cases of A and B where interest income is lower than the cost.

Further, Figure 6(b) shows the different loan terms for lending at the interest rate of 18% where loans will be approved (○) or rejected (×). For example, a 300,000 yen loan at 18% interest rate for 1 day (case A in Figure 6(a)) will not be approved for reasons stated above. In case of a 300,000 yen loan at 18% interest rate for 4 days (case C in Figure 6(a)), lending will be approved as interest income exceeds the cost.

We made this estimation on the assumption of "no credit loss" and "no procurement cost." However, the credit loss rate and funding cost of major consumer finance companies are normally 8~10% and 2~4% respectively, which means that loans are probably even less available in the actual market. Generally, short-term loans in a small amount have the highest social needs. However, as noted above, strict regulations on interest rates have made some of the short-term loans in small amounts unavailable. This is also one of the causes of credit shrinkage.

In future, we hope to conduct surveys and hearings to find out the impacts of credit shrinkage caused by legal amendments with an multifaceted analysis.

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Figure 1 Outstanding loans (as of end of month) and monthly loan approval rate of 7 major consumer finance companies

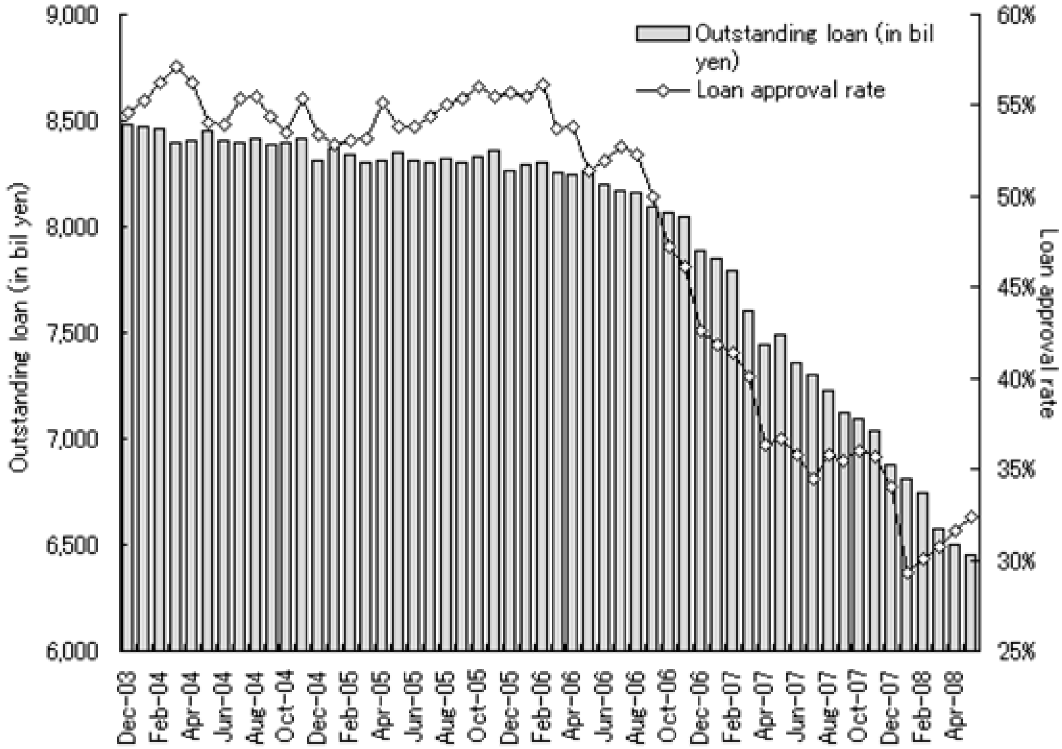


Figure 2 Percentage of consumer finance users borrowing from other sources and balance of such borrowings (Multiple answer)

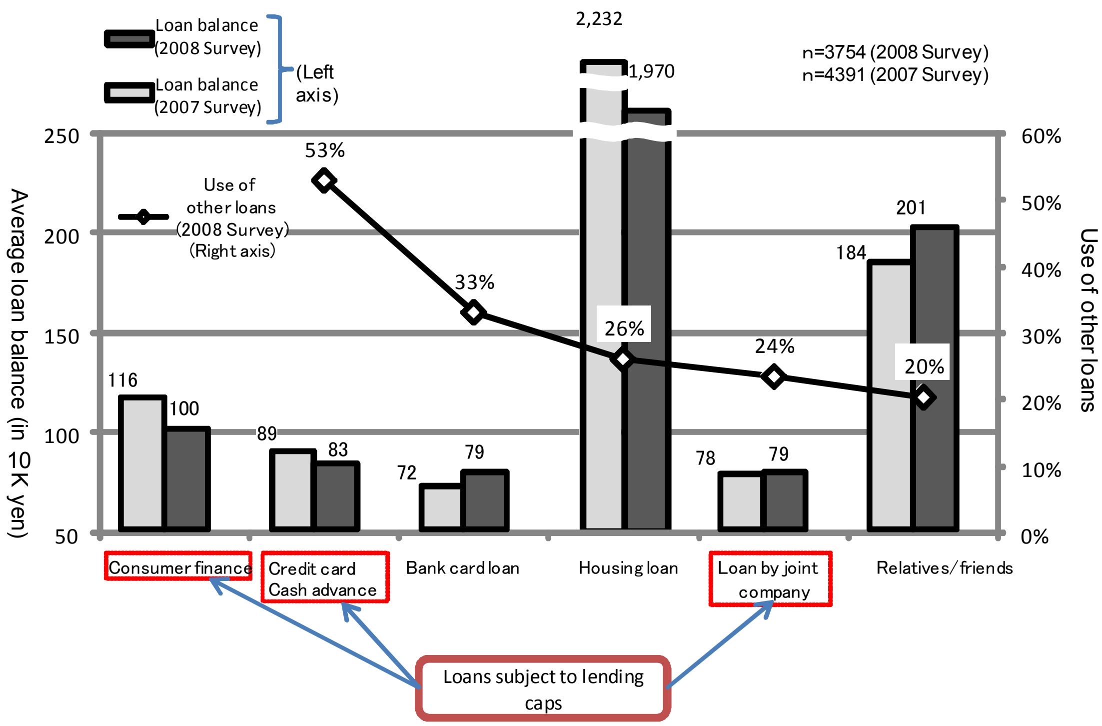


Figure 3 Actions taken by those who "did not receive financing they wished for" according to use of funds (Multiple answer)

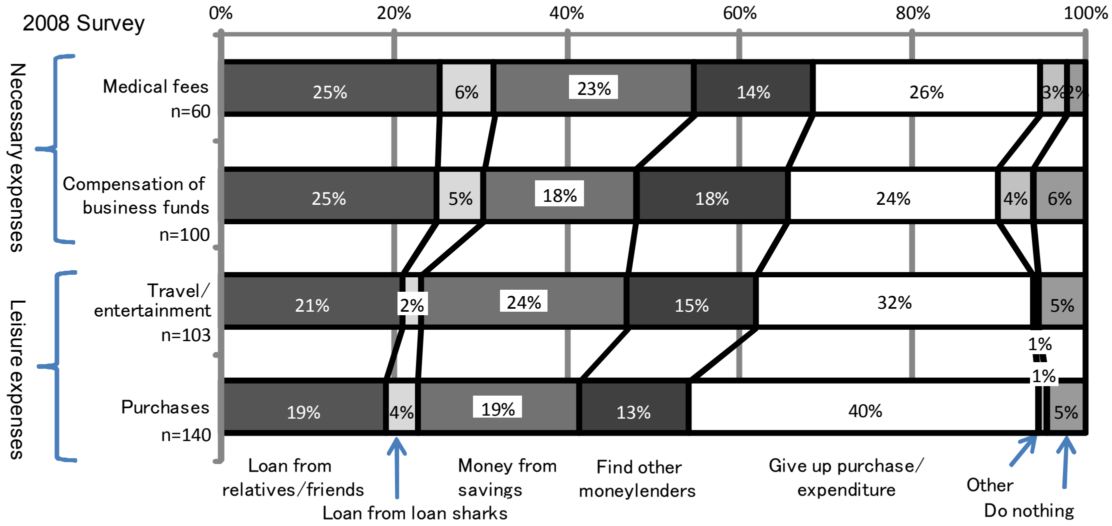


Figure 4 Applicants contacting loan sharks, depending on availability of loan (2007 vs 2008) (Multiple answer)

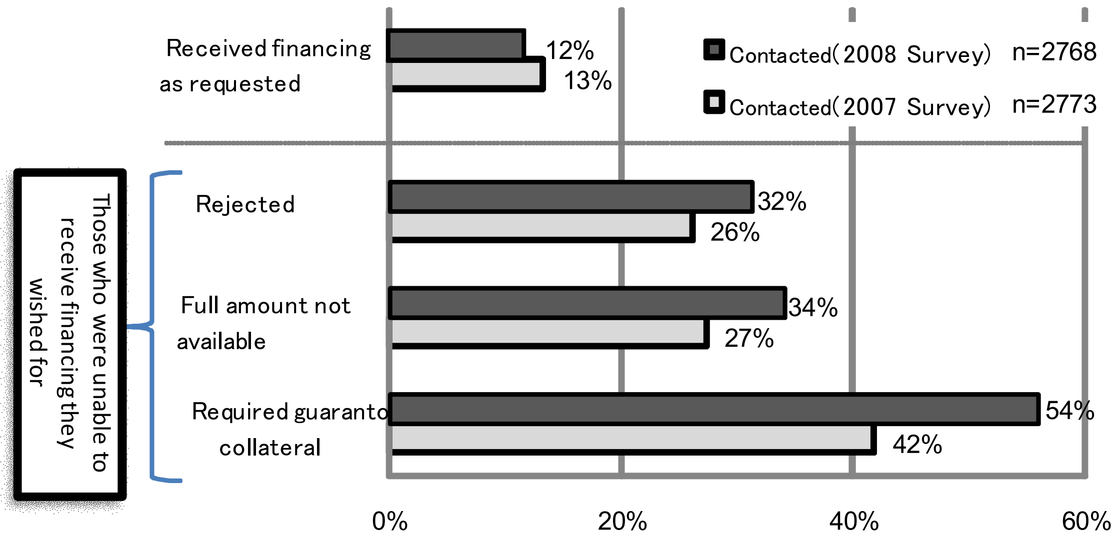


Figure 5　Source of financing used by very small business owners in the past year (Multiple answer)

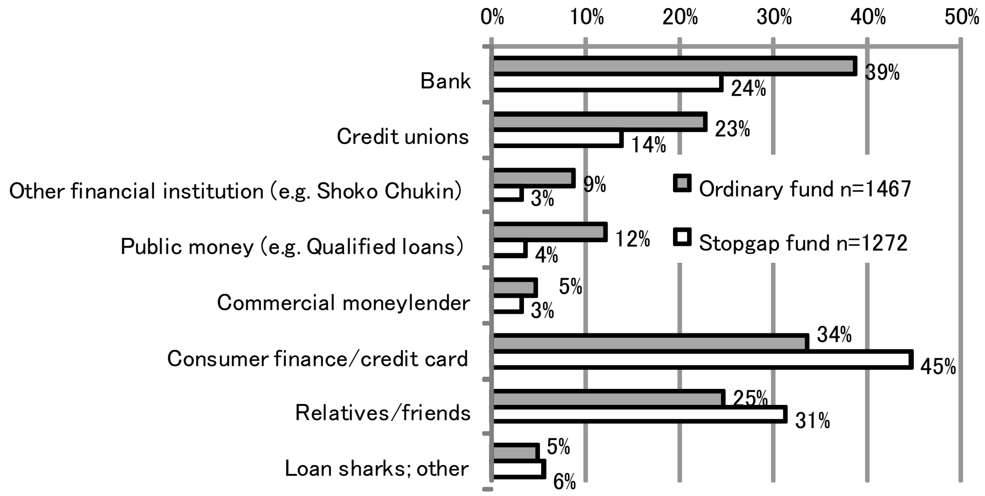
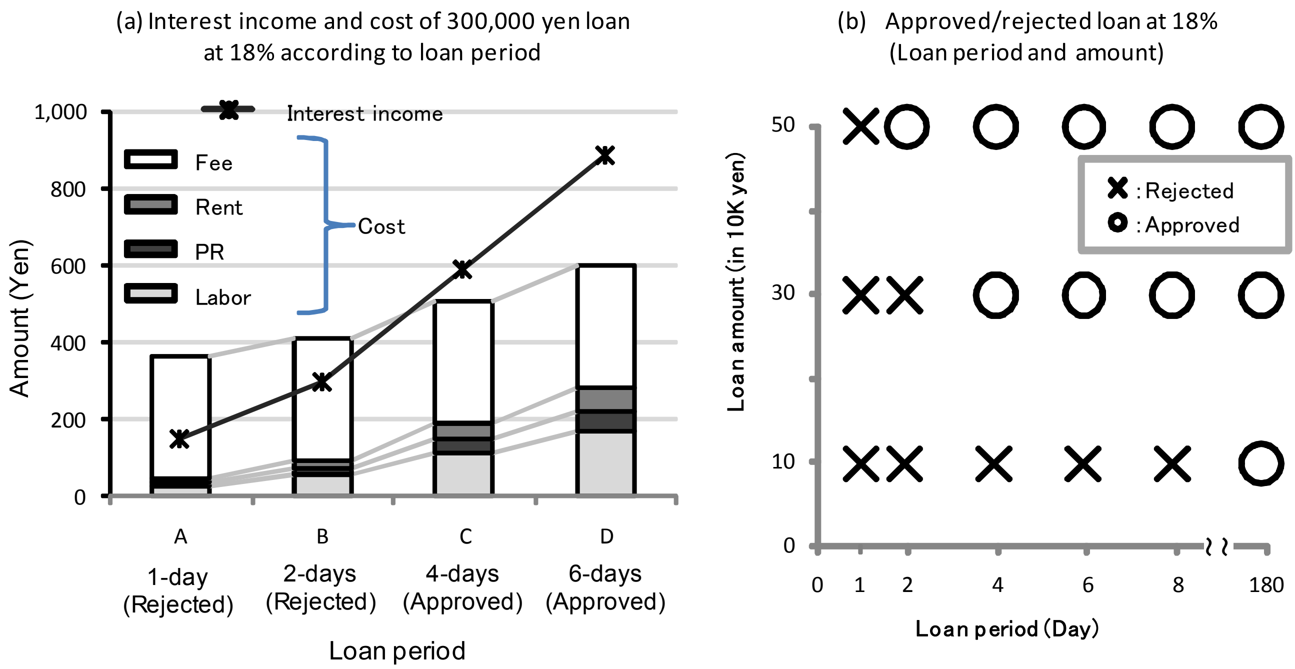


Figure 6　Short-term loans in small amount to be rejected (Assumption: No credit loss and no procurement cost)



N.B.　In actual cases, credit loss rate of 8~10% and procurement cost of 2% will be added to the outstanding loans.

[i] "Money Lender Surveys" When: July 2008; Who: 7 major specialized consumer finance companies. The loan approval rate was calculated from the number of new applications received and number of new contracts executed by the 7 major companies.

[ii] "Survey on use of consumer finance" When: 2008 survey in May, 2008 (2007 survey in May 2007); How: Via the Internet; Who: General consumers at the age of 20 or above who are registered with an research agency

[iii] "Use of money lending service by very small businesses" When: 2008 survey in May, 2008 (2007 survey in May 2007); How: Via the Internet; Who: Independent contractors and company owners at the age of 20 or above who are registered with an research agency