Working Paper

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Survey of the Consumer Loan Market and Illegal Lending after the Revision of the Three Principal Statutes on Money Lending

【Preliminary data】

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1. Introduction

A growing number of willing borrowers don't find lenders. According to the seven major consumer loan companies, the balance of outstanding consumer loans has contracted by 40 percent from its peak to 4.9 trillion yen (Chart 1(a)). Behind this decline is the December 2006 revision of the three principal statutes on money lending (the Money Lending Business Law, the Interest Rate Restriction Law, and the Law Concerning the Regulation of Receiving of Capital Subscription) intended to protect borrowers plagued by crushing debt. With interest rate ceilings for loans slated to be lowered from 29.2 percent to 20.0 percent by June 2010 at the latest, money lenders have tightened their lending criteria. Moreover, in the January 2006 judgment[1] the supreme court effectively rejected the so-called gray-zone 20.0-29.2 percent p.a. interest band between the ceiling rates prescribed by the Interest Rate Restriction Law, and the Law Concerning the Regulation of Receiving of Capital Subscription. After this revision, which renders the gray-zone interest band entirely unlawful, claims for refunds of overpaid interest (*kabarai*[2]) have surged. Chart 1(b) shows the ratio of new loan approvals to applications at the seven major consumer loan companies and the refunds of overpaid interest. Since the revision of the three principal statutes on money lending, tightened lending criteria have lowered

1 Case number 2004 (Ju) No. 1518, Case to seek repayment of loan (Supreme court).

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

the ratio of new loan approvals to applications from previously close to 55 percent to 30-33 percent. By contrast, refunds of overpaid interest remain on a rising trend, since the January 2006 court decision, to an industry-total of about 2 trillion yen. The surge in claims for refunds of overpaid interest has effectively led to the failure of money lenders' lending function.

Incidentally, since approximately 70-80 percent of claims for refunds of overpaid interest involve lawyers and judicial scriveners, who collect an average 31-35 percent of the refunded amounts as fees, it is estimated that total fees collected by lawyers and judicial scriveners since January 2006 amount at a minimum to somewhere around 500 billion yen[3]. This contrasts with media reports[4] of cases where lawyers' thoughtless debt consolidation has turned daily life into a challenge for the affected debtors.

This writer has since 2006 conducted Questionnaire Surveys of Consumer Loan Users[5] ("User Survey") and in October 2008 published research results on the situation in the consumer loan market as a working paper[6] at the Institute for Research on Consumer Financial Services of Waseda University. In the following sections this paper discusses latest developments of the consumer loan market, which has been thrown into even deeper turmoil by the subsequent financial crisis.

2. Analysis of the borrowing behavior of consumer loan users

(1) Effects of the law revision on borrowers

As Chart 1 shows, outstanding loan balances and the ratio of new loan approvals to applications started to decline in the spring of 2006 amid the mounting discussion over tighter regulations at the "Roundtable on Money Lending Business Regulations" of the Financial Services Agency. According to the writers' User Survey, at the time when the ratio of new loan approvals to applications plunged, lenders' loan approval behavior displayed specific leanings with regard to applicants' employment attributes. Thus, unsuccessful loan applications by type of employment were applications from managers and corporate officers, temp agency staff, and the self-employed. Unsuccessful loan applications by type of industry comprised transportation, construction, and catering and hospitality (Chart 2). At the same time, applicants' efforts to obtain a loan tended to be unsuccessful to the extent that the applicant was employed with a small business. These results, amid a spreading credit contraction, tell of a progressing lending crunch affecting workers with uncertain future income prospects.

The tightened regulations for the consumer loan market have affected also other types of lending. Chart 3 shows the balance of consumer loan users' current consumer loans, bank card loans, and loans from relatives and friends. According to Chart 3, borrowers' average outstanding balance from

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[3] Hiroshi Domoto, March 2009, "The market seen from the perspective of the survey on consumer loan usage"; " White Paper on Consumer Finance 2008" JCFA

[4] For example in the Yomiuri Shimbun, morning edition, September 11, 2009, "Questionable ethics of vendors of legal services."

[5] "Survey on the usage of consumer loans" conducted in the month of May of 2006-2009 via the internet with respect to general consumers aged 20 and higher registered with research institutions.

[6] Hiroshi Domoto, October 2008, "New Challenges after the Amendment of 3 Money Lending Related Laws -Close monitoring needed on loan sharks and impact on very small businesses-", IRCFS08-001

consumer loan companies has declined from 1.16 million yen in 2007 to 0.98 million yen in 2009. Bank card loans on the other hand have climbed from 0.72 million yen in 2007 to 0.88 million yen in 2009. And loans from relatives and friends have increased from 1.84 million yen in 2007 to 2.15 million yen in 2009. The ceiling for the total debt balance[7] introduced by the revised Money Lending Business Law in order to curb the number of so-called multiple borrowers[8] puts significant constraints on consumer loan companies' lending. In spite of these measures, judging by the borrowing behavior of users, the tightening of consumer loan market regulations bears the signs of a zero-sum game inasmuch as it addresses symptoms rather than root causes.

(2) Diminishing funding instruments for small business operators

The same trend is reflected in the questionnaire survey[9] of small business owners[10]. As Chart 4 shows, according to the 2009 survey, among loans taken in the last one year by small business owners, for bridge financing (maturities of up to six months) the order was (i) relatives and friends, (ii) consumer loan companies and credit cards, and (iii) banks. However, compared with the 2008 survey, in 2009 the percentage for loans from relatives and friends remained unchanged, the weighting of consumer loans and credit card loans declined by 9.4 percentage points to 28.5 percent, but the weightings for credit associations and credit unions and public funds increased respectively by about 2 percentage points.

On the face of it, this suggests that support measures such as the "Safety Net Lending" program incepted in the last autumn by the government are functioning effectively and, as it seems, funding costs for small business owners have come down. However, opinions in interview surveys with small business owners[11] who previously used consumer loan companies were not necessarily positive.

- **"A non-bank stopped lending where I had been borrowing and always repaid on time. At year-end I started using the Safety Net Lending program through a credit association, but it took one month until I had the loan funds." (*Osaka prefecture; real estate business*)**
- **"I applied for the Safety Net Lending program to cover year-end funding needs, but due to the laborious and time consuming application procedures, my business suffered in the year-end selling season. Despite the good market thanks to the eco-point scheme, I lost some orders because funds borrowed from non-banks were not enough to stock full inventory." (*Hyogo prefecture; electrical installations***

7 Loans by finance companies as a rule are limited to one-third of the borrower's annual income. Excluded are loans from banks and loans from relatives and friends. Scheduled to take effect in June 2010.

8 The term "multiple borrower" has no clear definition. For example, the definitions for "multiple borrower" used by the Financial Services Agency and the Japan Federation of Bar Associations are at variance.

9 "Survey on the use of money lenders by small businesses" conducted respectively in the month of May of 2007-2009 via the internet with respect to sole proprietorships and company owners aged 20 and higher registered with research institutions.

10 For the purposes of this paper, small business owner means owners of sole proprietorships with five or fewer employees or owners of companies capitalized at 20 million yen or less.

11 Interview survey conducted in July 2009 jointly with the Tokyo Foundation.

***business*)**

- **"In the wake of the Lehman Brothers debacle, a U.S. company closed its far east division in Japan. This caused revenues to plunge at the restaurants located in the same building. Unfortunately this happened immediately after a non-bank's refusal to lend, causing a temporary cash shortage which was impossible for me to resolve. I had to close the business." (*Osaka prefecture; catering business*)**

Moreover, Chart 4 displays notable growth in the weighting of loans for the category "Loan sharks, others."

(3) Diversification in illegal lending and softening business practices of loan sharks

Since the lowering of the ceiling for interest on loans in 2000 from previously 40.004 percent to 29.2 percent, rampant loan sharking has become a public concern in Japan. Today, on the face of it, loan sharks appear to be kept in check by countermeasures taken by law enforcement as a lesson drawn from the previous experience. However, responses of borrowers to the questionnaire survey suggest that under the surface this market is a stronger presence than expected.

Chart 5 shows the percentage of borrowing from loan sharks in the last one year by borrowers who have previously borrowed from loan companies and the usage ratio for monetizing shopping credit facilities.[12] Incidentally, billboards in downtown areas offering cash advances on credit cards have been proliferating in recent years. This service for monetizing credit card shopping credit facilities is in itself a derivative form of loan sharking. According to Chart 5, the percentage of loans from loan sharks rose from 2.9 percent in 2007 to 3.1 percent in 2008, but decreased to 2.7 percent in 2009. The usage rate for monetizing shopping credit facilities rose from 1.8 percent in 2008 to 2.7 percent in 2009, which reflects strong enough growth to absorb the fall in the ratio for loans from loan sharks.

Moreover, according to media coverage, there has been a softening in the business practices of loan sharks.[13] In 2008 and 2009 we asked and compared the opinions of users who have previously borrowed from loan sharks. As Chart 6 shows, the ratios of respondents who said they "regret the experience" and that "the high interest rate makes repayment difficult" both fell by ten percentage points or more compared with the year before, pointing to a softening in the business practices of loan sharks. However, for borrowers who turned to loan sharks to supplement their livelihood (i.e., food and other daily expenses) after being refused loans by consumer loan companies, there was an increase in the percentage of responses "regret the experience" and "the high interest rate makes repayment difficult" (Chart 6). While further in-depth analysis is needed, this finding raises the possibility that

[12] Pseudo-financing whereby the applicant in accordance with the instructions of the lender purchases expensive goods with a credit card's revolving loan facility. The purchased goods are subsequently sold to the lender for cash. This method results in high funding costs. Under the existing laws of Japan, this business model is not necessarily illegal.

[13] For example in the Sankei Shimbun, September 13, 2009, "Consumer loan companies make inroads into loan sharking."

loan sharks have started to practice borrower segmentation according to his/her credit risk.

As the foregoing shows, loan sharks and other illegal lenders remain an affliction to society, and likely to be hidden from view. Having said this, as a postscript, some survey respondents found that borrowing from loan sharks solved their problem.

3. Conclusion

The problem of crushing debt has no simple solution. To be sure, there exists no precedent of a nation that has achieved a genuine solution through interest regulation and facile debt consolidation. One need not look overseas for examples. The Kamakura shogunate (1192 - 1333) with its *Einin* cancellation order[14] (1284), the Muromachi shogunate (1338 - 1573) with its randomly issued debt cancellation orders, and the Edo shogunate (1603 - 1867) with its abandonment orders (1789 and 1843) issued to extinguish the financial obligations of samurai in the service of the shogun, by choosing the wrong measure for resolving this issue in the final days of their regimes plunged the economy into turmoil and weakened the administration.[15] In order to avoid repeating past mistakes like these, a radical policy review grounded in scientific analysis is therefore required.

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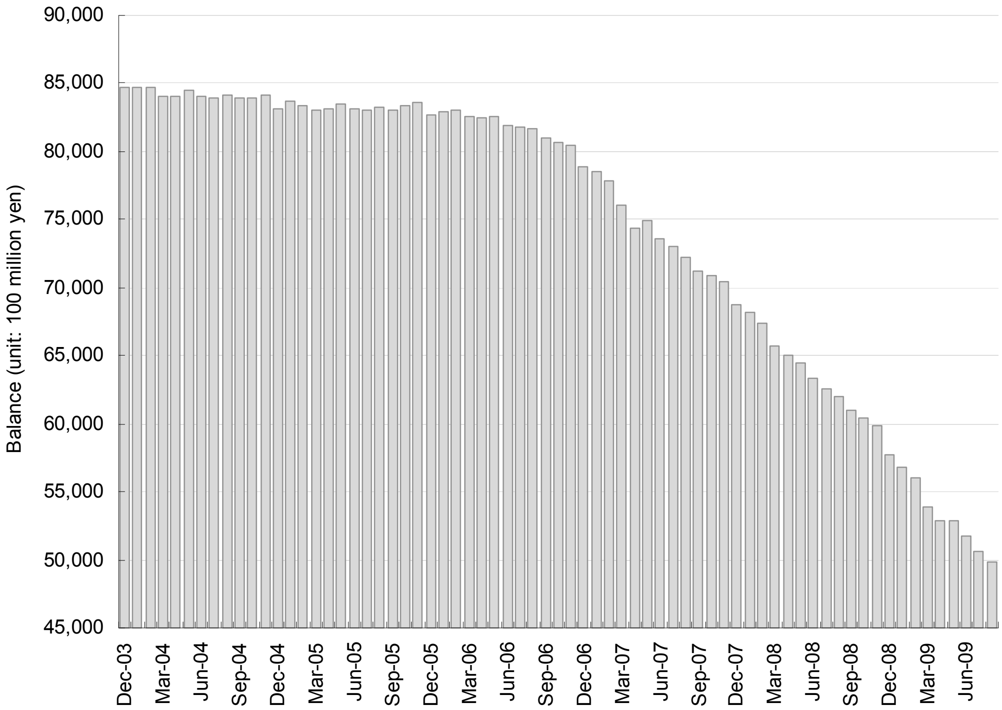
[14] A policy that wipes out samurais' entire debt. The "abandonment orders" during the Edo period amounted to about the same.

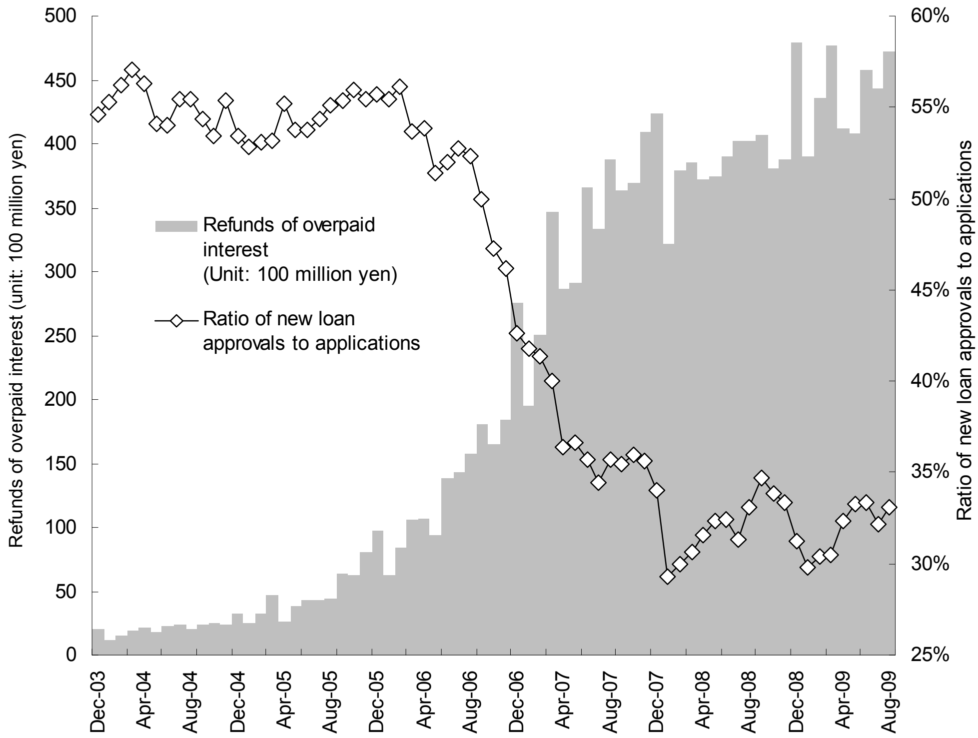
[15] The Liberal Democratic Party (LDP), which in Japan promoted the revision of the three principal statutes on money lending, was defeated in the lower house elections. On September 9 a new government was formed by the Democratic Party of Japan (DPJ).

Chart 1: Outstanding loan balances, ratio of new loan approvals to applications, and refunds of overpaid interest at the seven major consumer loan companies

(a) Outstanding loan balances (month-end)



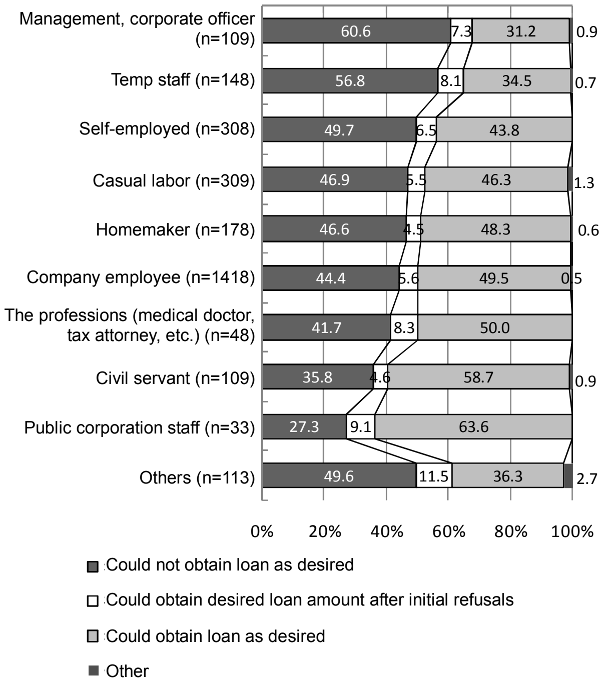
(b) Ratio of new loan approvals to applications (monthly average) and refunds of overpaid interest (monthly totals)



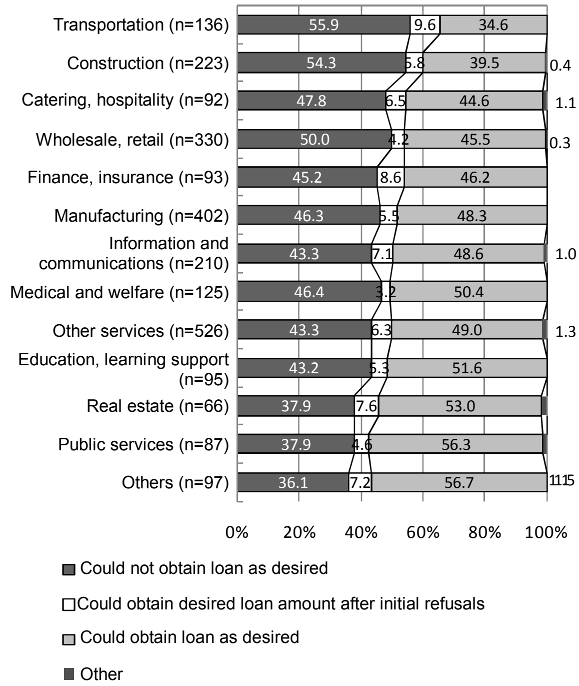
Source: “Questionnaire survey of fund providers” conducted in September 2009 of the seven major consumer loan companies

Chart 2: Ratios of new loan approvals to applications for consumer loans viewed by occupation and by industry (The letter “n” in the chart indicates the sample size. The same applies in the following charts.)

(a) By occupation

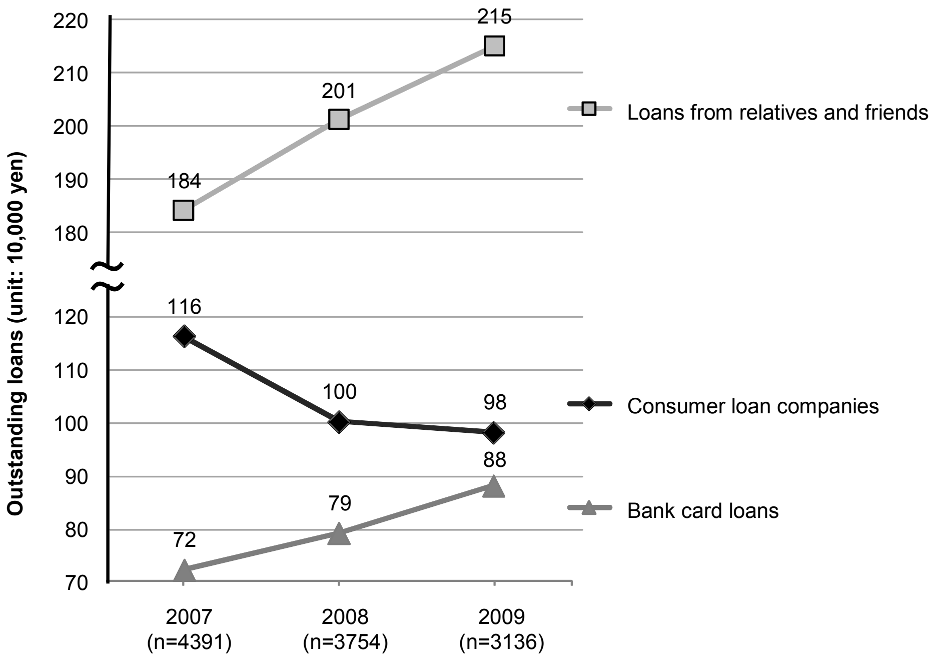


(b) by industry



Source: “Consumer Loan User Survey” 2007

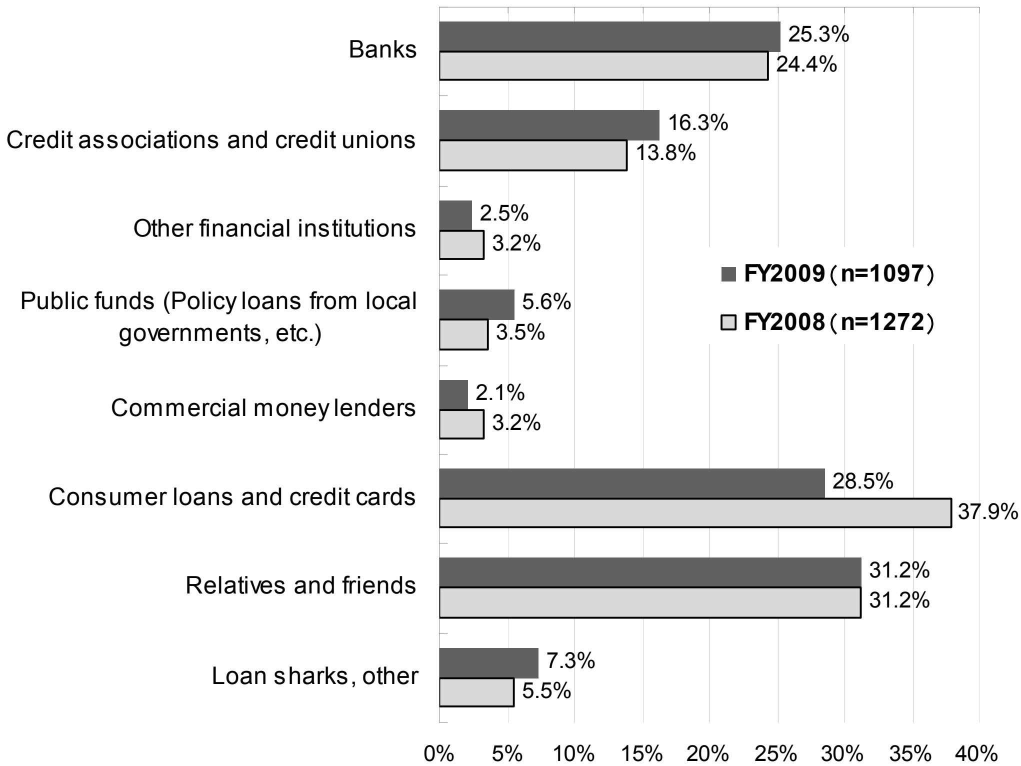
Chart 3: Outstanding loan balances of consumer loan users



Source: “Consumer Loan User Survey” 2007, 2008, and 2009

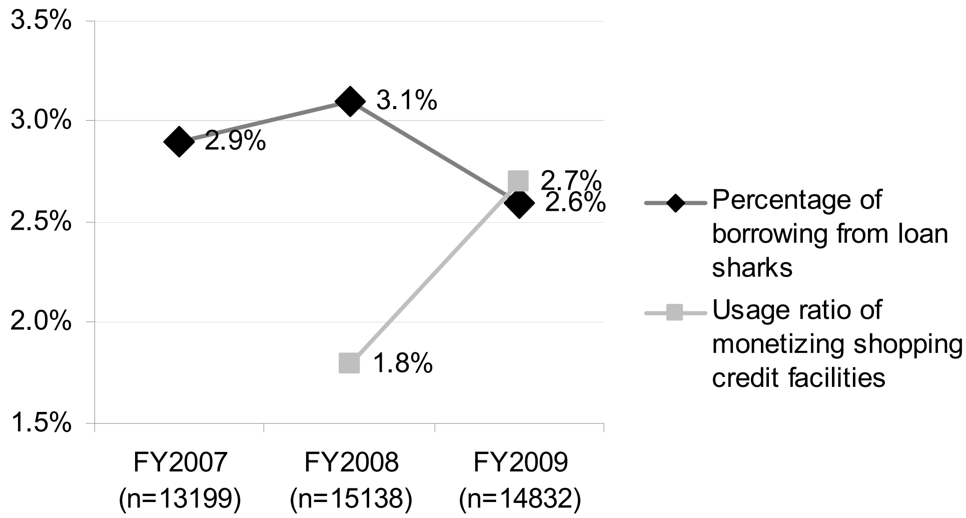
Note: Bank card loan usage ratios of consumer loan users were 32.9 percent (2007), 33.1 percent (2008), and 31.8 percent (2009). Usage ratios for loans from relatives and friends for the same periods were 24.6 percent, 20.4 percent, and 22.4 percent.

Chart 4: Change in lenders of bridge finance used by small business owners in the last one year (multiple answers)



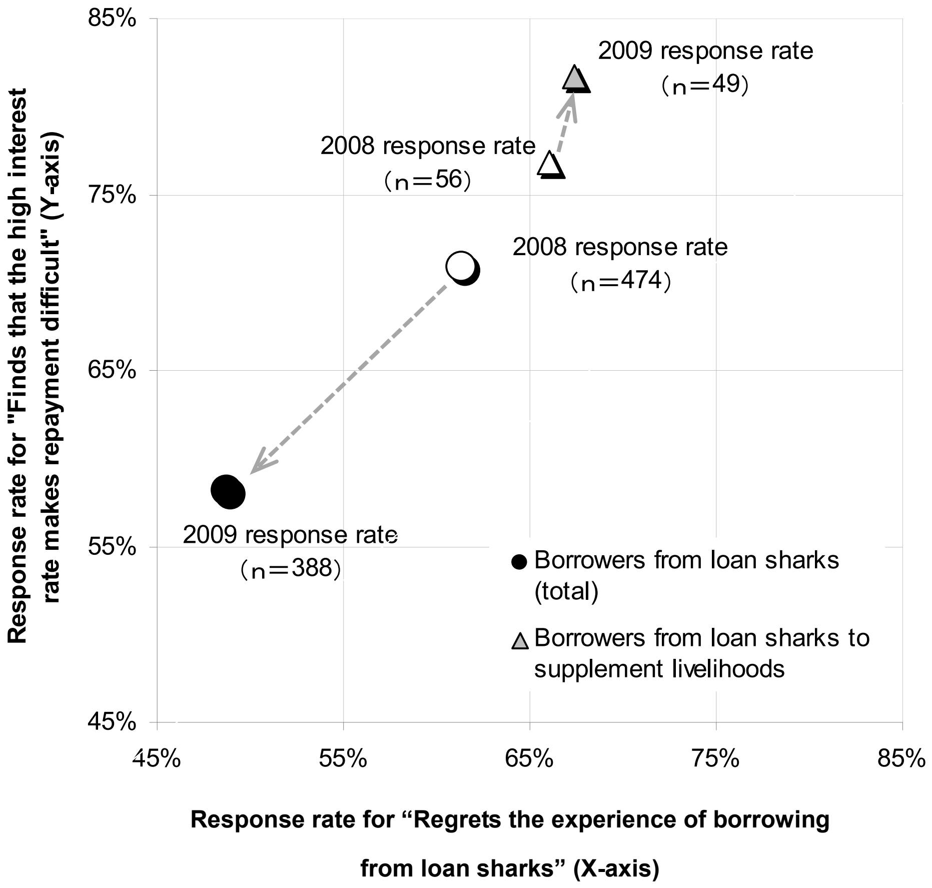
Source: “Survey of loan usage by small businesses” 2008 and 2009
Note: Aggregation on a bridge finance borrower basis. Bridge finance was raised by 24.4 percent in 2009 and 30.4 percent in 2008 of small business owners.

Chart 5: Percentage of borrowing from loan sharks and usage ratio of monetizing shopping credit facilities in the last one year



Source: “Consumer Loan User Survey” 2007, 2008, and 2009
Note: The usage ratio of monetizing shopping credit facilities in 2007 was not surveyed. The usage ratio for 2008 was estimated based on a supplemental survey (n=1200).

Chart 6: Change in the perception of borrowers from loan sharks



"2008 Survey Response Rate"

[Total]

- Regrets the experience of borrowing from loan sharks: 61.4%
- Finds that the high interest rate makes repayment difficult: 70.9%

[Borrowing to supplement livelihood]

- Regrets the experience of borrowing from loan sharks: 66.1%
- Finds that the high interest rate makes repayment difficult: 76.8%

"2009 Survey Response Rate"

[Total]

- Regrets the experience of borrowing from loan sharks: 48.7%
- Finds that the high interest rate makes repayment difficult: 58.2%

[Borrowing to supplement livelihood]

- Regrets the experience of borrowing from loan sharks 67.3%
- Finds that the high interest rate makes repayment difficult 81.6%

Source: "Consumer Loan User Survey" 2008 and 2009