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Anxiety about the Full Implementation of the Revised Money Lending Business Law

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(1) Introduction

The Money Lending Business Law (MLBL) was revised on December 2006, and will come into full operation on June 18 in 2010. As a result of the legal amendment, money lenders have tightened their credit standards in anticipation of this change and loans to high risk borrowers in particular dropped significantly. In order to capture the consumer finance market suffering from credit shrinking, my study group conducted user surveys during May 2009 and May 2006. Through these surveys, we can find out the impacts of credit shrinkage caused by the legal amendments. Therefore, I have contributed the two reports concerning the realities to the shrinking consumer finance market on “Economics Classroom”¹ of *Nikkei Shimbun*. In this research material, I published these reports as English version, again.

¹ “Economics Classroom” is 「経済教室」 (*Keizai-Kyoshitsu*) in Japanese.

(2) REPORT 1:

COUNSELING IS BEST SOLUTION to Solve Over-indebtedness Issue

(February 26, 2008, *Nikkei Shimbun*)

Abstract:

A more effective way to solve the over-indebtedness issue is to provide more counseling. Europe and the U.S. both have good programs to help debtors by creating a debt management plan, which has contributed to reducing delinquencies. Lending standards has been tightened in Japan due to the regulation on maximum interest rates and we need to pay attention to those who become “miserable because loans are no longer available.”

More Regulations on Interest Rates: Evident Side Effects

The amended Money Lending Business Law was enacted in December 2006 and provided for the maximum interest rate to be lowered from 29.2% p.a. to 20% p.a. by 2010 at the latest. This was intended to bail out over-indebted borrowers who became “miserable because of loans,” but on the other hand, tighter regulations on interest rates have caused a side effect on others to become “miserable because loans are no longer available.” The fact is that moneylenders are tightening their lending standards in response to the lowering of maximum interest rates, thereby reducing funding to high credit risk customers. The loan approval rates at major consumer finance companies have fallen from 55% to 30% in the past year. Can regulating maximum interest rates possibly be the ultimate solution to the over-indebtedness issue?

An attempt to solve the over-indebtedness issue by regulating interest rates is rarely seen in other developed countries. The U.S., currently suffering from the subprime loan problems, in effect has no maximum interest rate at the national (federal) level. (Moreover, federal preemption of state laws allows national institutions such as credit card issuing banks to “export” their rates nationwide from home states with high or no interest rate ceilings notwithstanding other state laws with lower ceilings, effectively meaning no maximum interest rate regulation on the most prevalent forms of credit..) Similarly, the U.K. has had a market of unregulated interest rates for many years and various financial products are made widely available to consumers and businesses.

These countries place emphasis on financial education and relief for borrowers. In the U.S., in particular, credit counseling is widely used as a method to provide education and relief to troubled debtors. Their diversified market is achieved by such infrastructure.

Following is how it works in the U.S.

In the 1960's, a number of non-profit consumer credit counseling agencies were set up, and there are more than 2,000 credit counseling services in operation today. Some 2.5 million troubled debtors are using the service annually. One of the feature services available through credit counseling in the U.S. is the debt management plan (DMP) offered to heavy debtors. DMP comprises of (i) negotiating with lenders on behalf of borrowers to relax the repayment terms (debt adjustment); and (ii) providing counseling care and assisting with household budgeting reforms.

If the debtor is capable of self rehabilitation, he/she will only receive the service mentioned in (i), but normally, counseling care and household budget monitoring continue for three to four years depending on the individual circumstances of the debtor. The credit counseling services are primarily funded by donation from creditors. Each time the debtor makes its monthly repayment under the DMP, around 8% of the repayment amount is paid to the counseling agency through its upper organization.

Acquiring Financial Management Skills

There has been some criticism in recent years when counseling became highly in demand and counselors started using standardized DMPs to cope with the strong demand. However, DMP is largely recognized by the public as an effective tool. According to a research released by a study group led by Dr. Staten at Georgetown University in 2002 which tracked 14,000 debtors who experienced credit counseling over three years, it was found that: (i) creditworthiness of the debtor improved because of counseling; (ii) counseling was particularly effective with debtors with relatively poor credit at the time of counseling; and (iii) customer delinquency substantially improved in three years.

Borrowers who became “miserable because of loans” not only enjoyed financial benefits through debt adjustment but also learned how to manage their finances.

Creditors also benefit from DMPs. There is greater incentive to participate in a DMP for lenders of unsecured loans. This is because when a debtor goes into liquidation proceedings, the debt become uncollectible.

On the other hand, mortgage lenders are able to recover the debt by selling the collateral and will have a lower incentive to participate in a DMP when the real estate prices are rising. However, due to the recent downturn in the housing market, lenders are more interested in collecting the debt by easing the repayment terms rather than selling the collateral at a price substantially lower than the loan principal. There is likely to be greater attention paid to credit counseling coupled with DMP as one solution to the subprime problem both in terms of debtor relief and debt collection.

Credit counseling in Japan, in contrast, is very weak in comparison to its market size. Some of the reasons are: (i) lenders were not interested in helping the borrowers; (ii) debt adjustment is a monopolized service only permitted to be undertaken by lawyers and judicial scriveners; (iii) loans charging the so-called gray-zone interest rate have become subject to *Kabarai* claims² and lawyers and judicial scriveners are not motivated to provide continuous support to debtors because they can earn a portion of the refund from lenders as contingency fee (20-30% of the refund amount) in addition to retainer fees by handling a debt adjustment; and (iv) the battle between lenders and lawyers over the vague legal interpretation on gray-zone interest rates have become increasingly fierce.

However, in comparison with the effects of credit counseling mentioned above, the current solution in Japan that relies primarily on debt adjustment does not really save borrowers who became “miserable because of loans.” This is clearly demonstrated in the survey of consumer loan borrowers conducted by my study group in 2007.

Figure 1 shows a scattergraph with self-control (patience) as X-axis and sociability (social inclination, to be more precise) as Y-axis based on the survey results. For the purposes of analysis, current borrowers having difficulty with repayment are grouped as “Troubled Debtors,” which comprise 25% of current borrowers. Further, former borrowers who fully

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*).

repaid the debt with their own income and those who were subject debt adjustment are categorized as “Fully Repaid Debtors” and “Debt Adjustment Debtors” respectively.

You can see from the figure that Fully Repaid Debtors are well-balanced and positioned near the middle point (5 points) of self-control and sociability. On the other hand, Troubled Debtors and Debt Adjustment Debtors both have less self-control and are positioned somewhat at the same level. However, Debt Adjustment Debtors have higher sociability than Fully Repaid Debtors.

The possible reasons for the high sociability of Debt Adjustment Debtors are: (i) sociability developed by speaking up and seeking help from others in the process of debt adjustment ; and (ii) the more sociable of the troubled debtors willingly chose to go for debt adjustment.

Consideration Needed for Legal Measures

What is important here is that Debt Adjustment Debtors have low self-control which may be the cause of recurrence. At the same time, while the high sociability of Debt Adjustment Debtors means that he/she has many friends, this is not desirable for someone with low self-control. It was confirmed in our study that those with exceptionally low self-control and exceptionally high sociability are likely to resort to loan sharks. In other words, debt adjustment without providing credit counseling is similar to kicking out a half recovered patient from the hospital and expecting them to heal on their own.

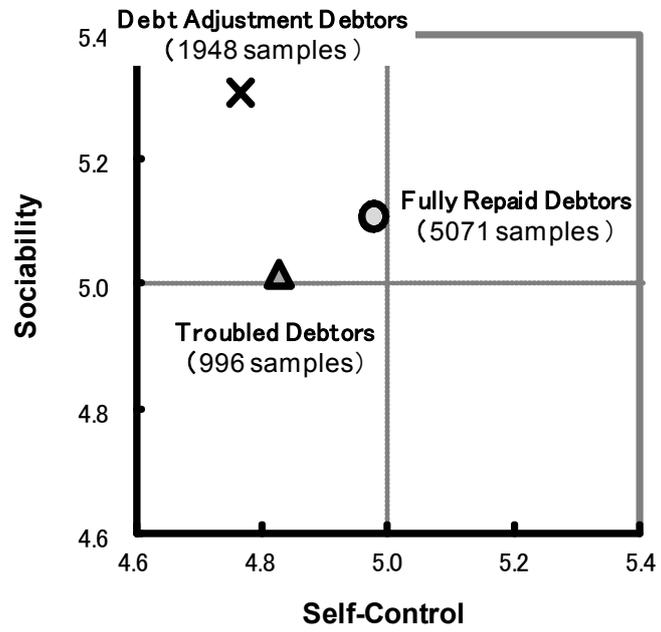
The recent amendment did not thoroughly consider provision of counseling to debtors who became “miserable because of loans.” Also, it is doubtful whether sufficient consideration was given to those who became “miserable because loans are not available”.

Some anticipated that “lowering the maximum interest rate will make low interest rate loans more available to high credit risk people,” but this was not the case. Our study indicated high loan refusal rates for those with attributes like “tiny business owner,” “manual labor” or “temp staff.” Also, we were unable to confirm any evidence showing that these high credit risk people have poor financial management skills.

The essential relief for over-indebted borrowers is to provide more credit counseling. One example is to conduct psychological testing on borrowers, as necessary, as part of a credit control process. A system should be established to lead borrowers to credit counseling once any psychological issue arises. The cost should be borne by the market and handled by

independent private expert counselors. There should be more consideration on credit counseling supported by legal measures as well as on how to regulate interest rates.

(Figure 1) Consumer Loan Borrowers' Psychology



(3) REPORT 2:

Considering the full implementation of
the revised Money Lending Business Law and multiple debt problem

(March 22, 2010, *Nikkei Shimbun*)

Main Points :

- ✓ Psychological aspects are an important aspect of aid for heavily indebted persons
- ✓ The decline in the ability of moneylenders to provide financing has led to an increase in people forced into difficult circumstances due to an inability to borrow
- ✓ Consumer credit also helps to mitigate income disparity

In December 2006, the Money Lending Business Law (MLBL) was revised with the aim of providing relief to so-called heavily indebted persons with multiple loans. Consumer finance firms have moderated their business ahead of full implementation of the law in June this year, and the balance of outstanding loans by the seven major companies has shrunk to ¥4.4 trillion, half its peak value. The revision to the MLBL lowers the maximum interest rate to 20% from 29.2%. This drastic measure of lowering the cap rate was triggered by a Supreme Court ruling in January 2006 that effectively prohibited the so-called “gray zone interest band” (20% to 29.9% annually), which was the difference between the maximum interest rates allowed under the Interest Rate Restriction Law (IRRL) and the Investment Control Law (ICL).³

In response to this series of court rulings and law revisions, the number of *kabarai* (overpayment) claims suddenly jumped. Since January 2006, the money lending industry overall is estimated to have returned *kabarai* payments amounting to around ¥2.3 trillion. One of the aims in revising the law was to help heavily indebted persons struggling to make ends meet by returning the *kabarai* payments to them. In contrast with this intention, however, the problem of shady *kabarai* claims by attorneys and judicial scriveners has received much attention in the media recently.

³ Case number 2004 (Ju) No. 1518, Case to seek repayment of loan (Supreme Court)

My colleagues and I conducted a tracking study (panel survey) over a three-year period, using questionnaires to look at changes in borrowing behavior prior to and after a *kabarai* claim. We then analyzed whether *kabarai* claims were contributing to improved borrowing behavior among heavily indebted persons. From people in the 2007 survey who had a balance with a consumer finance company, we extracted a sample of those who filed a *kabarai* claim at the time of the 2008 survey. We then made a comparison between the 2007 survey and the 2009 survey of the proportion who had requested a loan from a gray market operator, or asked family or friends for a loan.

We first used the 2007 survey to look at those who responded that they “Asked family or friends for loan” or “Requested loan from gray market operator,” and compared the total number of users of consumer finance services (13,199 samples) with users who filed a *kabarai* claim (193 samples). The proportion of persons who requested a loan from a gray market operator was 2.9% overall, while for users who had filed a *kabarai* claim in 2008 it was 9.8%. Similarly, the proportion of persons who asked family or friends for a loan was 20.3% overall, and rose to 32.1% among those who filed a *kabarai* claim. In essence, the survey showed that persons who utilize consumer credit financing and filed a *kabarai* claim are inherently predisposed to be dependent on borrowing from gray market operators, or friends and family.

Next, in order to assess the effectiveness of making a claim, we compared instances of borrowing from friends and family, and from gray market operators between before and after a *kabarai* claim. More specifically, we used a statistical analysis method called a McNemar's test to determine whether instances of borrowing from friends and family, or gray market operators, decreased after a claim. We were unable to confirm a significant difference (significance level 5%). In effect, the analysis demonstrated the likelihood that *kabarai* claims were ineffective in correcting borrowing behavior such as seeking loans from friends and family, or gray market operators.

This result means that simply making a *kabarai* claim without accompanying psychological support is not an effective way to help heavily indebted people. Lowering debt may help improve their cash flow in the short term, but a *kabarai* claim alone does nothing to address the underlying borrowing behavior of users prone to taking on excessive debt. For this reason, it is not substantive relief for the problem of heavily indebted persons. At the same time, as illustrated below, there is also a danger that these claims will lead to potential cases of users turning to a gray market operator because they find it difficult to borrow funds after making a *kabarai* claim and thus making the market go underground.

Financial counseling services are widely employed overseas as a means of helping heavily indebted persons. I pointed out the effectiveness of this system in this column on February 26, 2008. In developed nations such as the United States and Britain, debt adjustment is not limited to attorneys, but can be conducted at the grass roots level by local financial counselors to provide prompt and ongoing assistance to the heavily indebted. The fees are of course inexpensive.

In Japan, however, attorneys and judicial scriveners have a virtual monopoly in the debt adjustment business. One of the reasons for this is that while borrowers may legally recover excess interest payments themselves, debt adjustment by third parties other than attorneys or judicial scriveners is prohibited as an unauthorized practice of law.

Further, it is common practice for attorneys and judicial scriveners in a *kabarai* claim case to receive a contingency fee of 20% to 30% of the amount recovered from the moneylender, on top of the advance payment for the work. This has encouraged attorneys and other legal professionals to begin offering *kabarai* claim services.

Financial counseling that emphasizes the psychological aspect in providing assistance of borrowers, which has proven effective overseas, has been insufficient in Japan. At the same time, there is a strong possibility that the Japanese government's focus on *kabarai* claims as the means for substantive resolution of the problem of heavily indebted persons will not help those who have fallen into difficult circumstances due to borrowing.

Another issue that should not be overlooked is that the rapid increase in *kabarai* claims, and lowering of the maximum interest rate, has vastly reduced the capabilities of moneylenders to provide financing. The ratio of new loans has fallen to 28% from 55% prior to the law revision. In particular, the sudden constriction of loans to the category of borrowers that includes small business owners, and people in temp staff or part-time positions, has led to a rapid rise in persons forced into difficult circumstances due to an inability to borrow. Further, the cap on total borrowing amounts that will accompany full implementation of the law will reduce the credit lines of approximately five million users, leaving them to face a withdrawal of their credit.

In order to investigate the impact from a restriction to or withdrawal of credit, we looked at applicants denied financing by a consumer finance company, and examined their actions following the loan refusal. **Figure 2**

shows the results of our survey of the actions taken by users whose application for financing was rejected by a consumer finance company within the last year (multiple responses). In the 2009 survey, the number of people responding that they “Asked family or friends for loan” and “Restrained purchasing and otherwise tried to economize” accounted for 38.4% and 38.0% respectively, ranking high among such actions. With the rapid decline in the economy in 2009 the proportion of respondents who asked family or friends for a loan rose from the previous year, and the fact is also worth noticing that the market has gone increasingly underground.

An examination of this group by the intended purpose of the financing shows that among users who applied for a loan for medical fees or to help supplement business expenses, a higher proportion were likely to turn to a gray market operator. This result shows that not only has the revision to the MLBL led to an increase in the number of people forced into difficult circumstances due to an inability to borrow, it also suggests the possibility that it has driven certain users having difficulty procuring funds into the arms of gray market operators.

In order to confirm this point, I conducted interviews in November 2009 with owners of small businesses that had borrowed from gray market operators after having been rejected for financing.

A construction firm in Osaka became completely unable a few years ago to borrow from banks. The firm had since asked moneylenders for bridge financing as necessary. However, the company’s credit line has been reduced over the last 2-3 years. Recently unable to meet its month-end payroll, the company finally borrowed ¥300,000 with interest of 10% per 10 days from a gray market operator, and repaid it.

A service company in Tokyo had continually restructured its business for two years due to the decline of sales, but its cash flow temporarily deteriorated. The company applied for loans from several consumer finance firms but was rejected by all of them, and in an attempt to at least secure salaries for employees, pulled out a fax that had been sent to the company by a gray market operator, and contacted them. The company ultimately borrowed ¥300,000 from the operator, and settled the debt by paying ¥350,000 one month later.

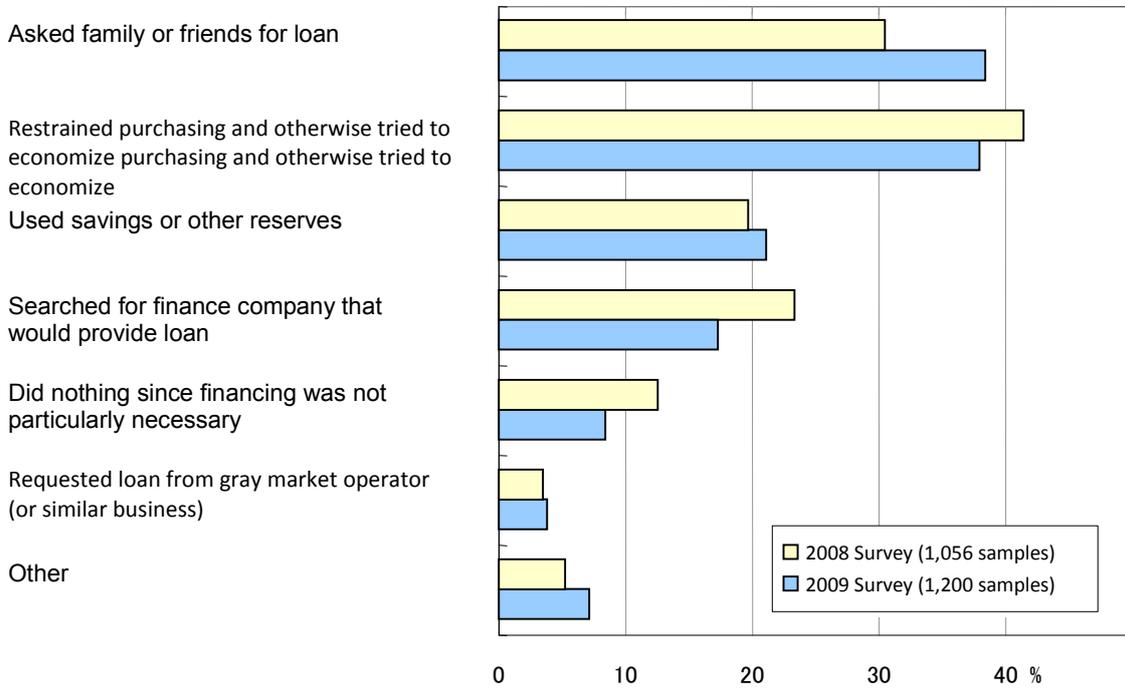
After the maximum interest rate was lowered in 2000, the proliferation of gray market loan operators became a social problem. This time, due to the success of measures taken by police that drew on the previous experience to counter these gray market operators, there is no sense that malicious gray market loan operators are operating behind the scenes. However,

considering the results of this survey, there is an undeniable possibility that the market has increasingly gone underground.

The consumer credit market does of course have the adverse side effect of producing users in difficult circumstances due to borrowing, including bankruptcy and becoming heavily indebted. However, the growth of consumer credit does more than just provide a benefit to the economy. Experimental studies have shown that by decreasing the number of people who would otherwise face difficulties due to an inability to borrow, making credit available also helps to mitigate any increases in lifestyle and consumption disparity.

The value of consumer credit ultimately outweighs its adverse effects, and measures to minimize them should be considered. In short, Japan should assist people who have fallen into a difficult situation due to borrowing with simpler debt adjustment, and coax them toward ongoing financial counseling. The current policy has not only swelled the ranks of persons facing difficulty as a result of an inability to borrow, but has fundamentally failed to help those in difficult situations due to borrowing. Japan needs to make carefully considered decisions from the standpoint of protecting persons in need of capital.

(Figure 2) Subsequent Action of Users Refused Financing



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