Asia Focus

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JAPAN'S NEW CONSUMER FINANCE LAW

On December 13, 2006, the Japanese Diet enacted legislation revising the Money Lending Business (MLB) Law. The revisions to the MLB Law will likely have a major impact on Japan's consumer finance business by reducing profits and triggering consolidation. While the major consumer finance companies (CFCs) have announced steps to confront these challenges, the success of these strategies in the new lending environment is uncertain. Nevertheless, Japanese banks continue to rely on CFC expertise to assist their expansion into retail lending, and overseas investors have maintained their holdings in CFCs. Concerns remain about the potential economic impact of the law.

MLB Law limits lending rates

The main provision of the MLB Law lowers the allowable interest rate on uncollaterized consumer loans to a maximum of 20 percent. The bill also sets a limit on the total amount of outstanding debt a consumer can carry, raises market entry requirements for CFCs, and establishes a designated credit bureau for consumer lenders. The changes will be implemented in stages, with the interest rate restriction taking effect three years from passage of the law in order to allow the industry time to transition to the new environment.

Prior to the passage of the new legislation, Japan had two laws restricting consumer loan interest rates. The Interest Rate Restriction Law of 1954 set lending rates based on the size of the loan, with a maximum rate of 20 percent. The Investment Deposit Interest Rate Law, last amended in 2000, capped interest rates on consumer loans at 29.2 percent on the condition that any rate exceeding 20 percent requires the written consent of the borrower. Most Japanese CFCs have been operating in this "gray zone" of interest rates, charging rates between 20 and 29.2 percent.

The consumer finance industry faces criticism

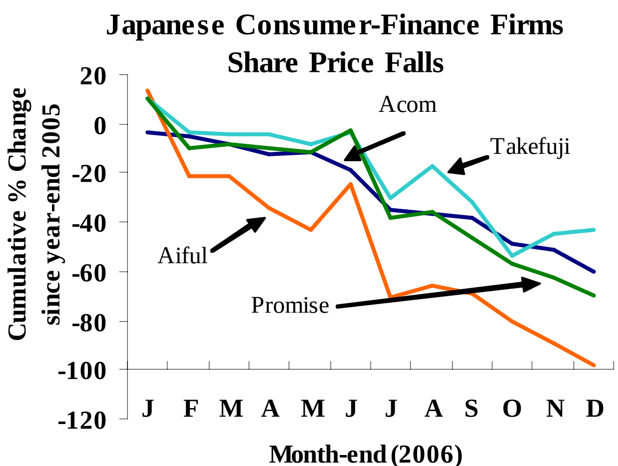
Non-bank consumer finance companies in Japan comprise a ¥20 trillion industry, averaging 4 percent annual loan growth over the past decade while bank loan growth was negative. Most of the approximately 14,000 registered lenders are small, with the largest seven operators-which include the consumer finance arms of GE Capital and Citigroup- having a 70 percent market share. The significant growth in this industry can be traced directly to the collapse of the asset bubble in the early 1990s when consumers whose collateral had dwindled in value turned to CFCs offering uncollateralized loans. Adding to the success of the industry was the fact that CFCs were more service-oriented than the retail operations of Japanese banks, offering a wider network of loan offices, 24-hour loan ATMs, and faster credit approval.

Public perception of the industry began to change in 2006 with a Japanese Supreme Court ruling against a CFC and the well publicized difficulties of one of the largest CFCs. In January 2006, the Japanese Supreme Court ruled in favor of a consumer borrower who sued over the contracted interest rate of 29.2 percent, decreeing that gray zone interest rates were illegal and ordering the defendant CFC to return all payments in excess of 20 percent. The verdict set a precedent and CFCs have since been confronted with increasing claims for compensation for excessive interest payments. As a result of the legal uncertainty created by the ruling, in October 2006, the Japanese Institute of Certified Public Accountants ordered CFCs to set aside sufficient reserves to cover the cost of refunding excess interest payments. Further contributing to the change in attitude toward CFCs were the publicized difficulties of Aiful, one of Japan's largest CFCs, in early 2006. Aiful was subject to a public business improvement order by Japan's Financial Services Agency, which required it to cease abusive collection practices, such as calling borrowers at their workplace, and forced the company to suspend operations for three days.

Industry profits are falling

The new legislation is expected to sharply reduce profits for the industry and lead to cost-cutting and industry consolidation. A shakeout among the smaller CFCs is expected, as more restrictions are phased in between now and 2009, and many are unlikely to meet the new requirements.

Even prior to the passage of the law, the major CFCs had experienced a significant decline in profitability. From March through September 2006, the four major Japanese CFCs recorded a total of ¥1.1 trillion in loan loss provisions, leading to combined net losses of ¥765 billion over the six-month period. The stock prices of the firms also have been on a steady decline since March of last year, partially reflecting investor expectations of additional troubles for the industry.



Source: Bloomberg

Restructuring plans are advancing

The four major CFCs noted above have focused on three strategies to ensure future profitability and growth: (1) cost-cutting, (2) geographic expansion, and (3) product diversification. Major lenders have already announced cost-cutting steps as a result of both recent losses and the legislation's passage. Acom, Aiful and Takefuji all plan to reduce the number of both staffed and automated branches over the next 18 months. Acom's planned branch reductions and additional staff cuts will reduce its work force by 20 percent. Moreover, major U.S. players are expected to re-evaluate the future of their involvement in the industry. Citigroup announced in January 2007 that it would close 80 percent of its consumer finance branches in the country after posting a $370 million fourth quarter loss in its Japanese consumer finance business.

Geographic expansion plans focus on markets outside of Japan, particularly Southeast Asia. Acom announced plans to expand into the region, together with its joint venture partner, Mitsubishi UFJ Financial Group (MUFG). Some lenders are considering product diversification by expanding into other consumer areas, such as credit card loans, as that industry enjoys a more favorable image and interest rates are already below the 20 percent cap. Many analysts believe, however, that geographical or product expansion may come too late, as most of the competition has already established its market position.

Megabanks remain involved

Major Japanese banks have looked to CFCs for expertise in implementing their plans for further expanding into consumer lending and strengthening their retail operations. In 2004, two of the major banks, MUFG and Sumitomo Mitsui Financial Group (SMFG) entered into strategic alliances with Acom and Promise, respectively. As yet, both bank groups have been slow to tap their partners' expertise in consumer loan underwriting and collection. The recent problems at the consumer finance firms forced MUFG and SMFG to book losses of ¥43 billion and ¥35 billion, respectively, on their equity stakes in the consumer lenders in the six-month period ending September 30, 2006. Nevertheless, both MUFG and SMFG have pledged to maintain their business ventures with these firms.

Foreigners maintain confidence

Foreign investors have taken a large stake in the leading consumer lenders due to their historically high profitability. In contrast to Citigroup's recent retrenchment, market analysts report that other overseas investors purchased additional shares of the firms during the six months through September 2006 despite their declining share prices. This may reflect their assessment that current share prices already reflect future losses resulting from the legislation.

Foreign Investor Ownership (%)

	9/30/2006	3/31/2006
Takefuji	54.8	53.3
Aiful	39.4	34.3
Promise	34.7	33.5
Acom	23.9	22.0

Economic impact remains uncertain

Potentially, the legislative changes could restrain Japan's economic recovery. There are concerns that the new lending restrictions could cause an increase in nonperforming loans and personal bankruptcies, as limits placed on total consumer debt may impact borrowers accustomed to servicing loans through other borrowings. Economic growth could also be slowed as consumers cut down on buying based on a lack of credit, with some analysts projecting up to a 0.7 percentage point impact on Japan's nominal gross domestic product. Nevertheless, the three-year implementation period for reducing interest rates is likely to blunt any immediate economic effect.

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