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# SME Finance in Japan

## ― *Experiences and Challenges* ―

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# 1. Difficulty of SME Finance

Small and medium-sized enterprises (SMEs) are extremely important to the Japanese economy.

- SMEs account for 44% of sales and 71% of employees in Japan

However, SME finance generally faces the following difficulties.

1) Larger credit risk
2) Lack of reliable information on financial statements
3) Difficulty of securing loans by collaterals
4) Larger monitoring costs

Furthermore, developing economies are likely to face the following difficulties.

- Shortage of domestic savings is likely to lead to credit rationing.
  ⇒ Private banks tend to prioritize lending to large enterprises in terms of efficiency.
- Less developed legal and regulatory frameworks, which may impede the development of bills and other inter-company credit.

# 2-1. SME Finance in Japan: Experiences of the High Economic Growth Period

The financial environment during Japan's high economic growth period was similar to what developing economies experience today.

- Large banks tended to ration credit, given excessive demand for borrowings and chronic shortfalls of domestic savings.

<Major policy initiatives in Japan>

1) Establishment of private banks specializing in SME finance

⇒ Creation of multilayered financial intermediation system

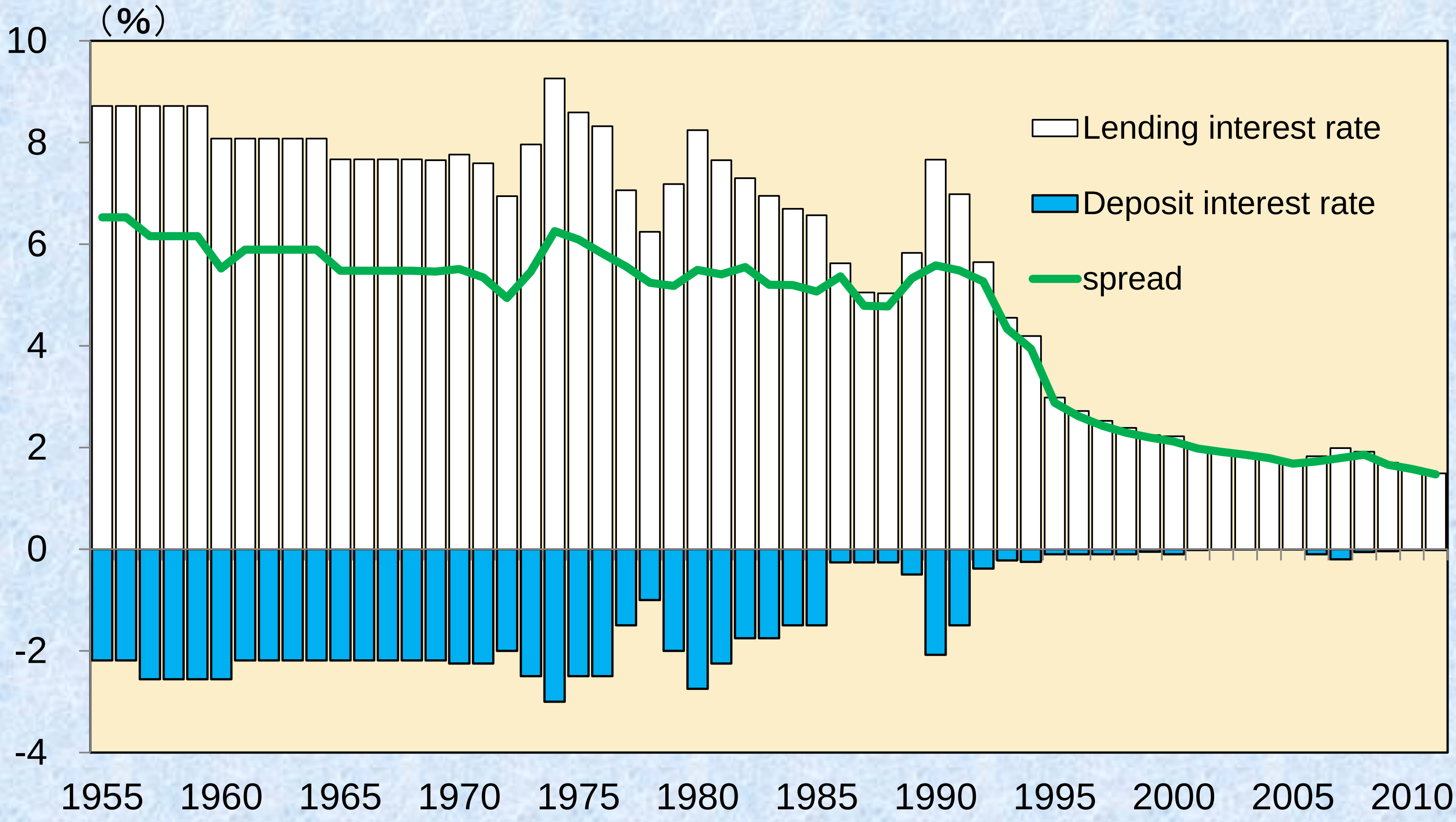
2) Enhancement of public support for SME finance

- Direct provision of long-term, concessional lending by government-affiliated institutions specializing in SMEs
- Establishment of credit guarantee corporations at the prefectural level to provide 100% guarantees of private banks' loan losses. Companies pay inexpensive guarantee fees regardless of their creditworthiness.

3) Regulations on interest rates of deposits

- Regulations on maximum deposit interest rates ensure sufficient lending spreads to cover credit risks and operational costs (Chart 1).

# (Chart 1) Interest Rate Spread bet. Lending and Deposit




Note: Deposit interest rate = Ordinary deposit interest

# 2-2. Monetary Policy Response

The Bank of Japan provided the necessary fund to private banks, secured with commercial bills and other corporate obligations

(Chart 2) Banks' Loan-Deposit Ratios and Dependence on Borrowings from the BoJ

| | Loan-deposit ratio (%) | | The ratio of borrowings from the BoJ (%) | |
|---|---|---|---|---|
| | All banks | City banks | All banks | City banks |
| 1951 | 108 | 124 | 17 | 25 |
| 1952 | 104 | 116 | 12 | 18 |
| 1953 | 103 | 114 | 13 | 19 |
| 1954 | 97 | 105 | 8 | 13 |
| 1955 | 89 | 93 | 2 | 3 |
| 1956 | 91 | 96 | 2 | 5 |
| 1957 | 98 | 107 | 10 | 16 |
| 1958 | 94 | 101 | 5 | 9 |
| 1959 | 91 | 98 | 4 | 7 |
| 1960 | 91 | 97 | 5 | 8 |
| 1961 | 94 | 102 | 11 | 18 |

Note:

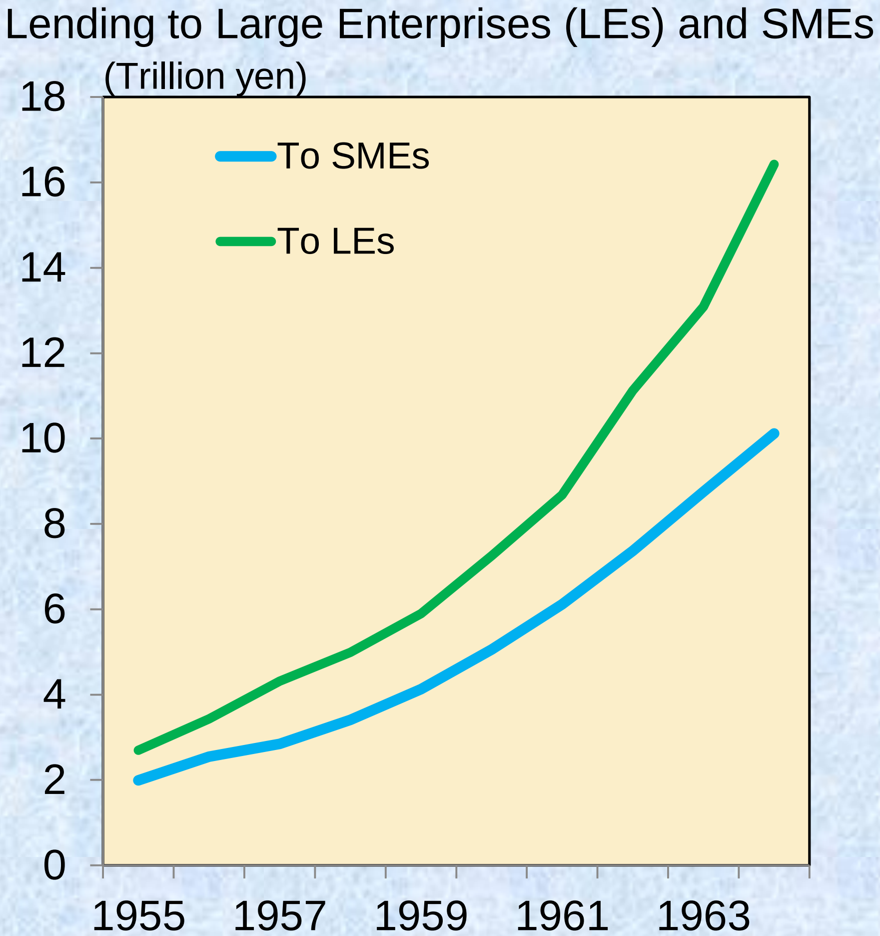
$$\text{Loan-deposit ratio} = \frac{\text{Loans}}{\text{Real deposits + Bonds + Capital}}$$

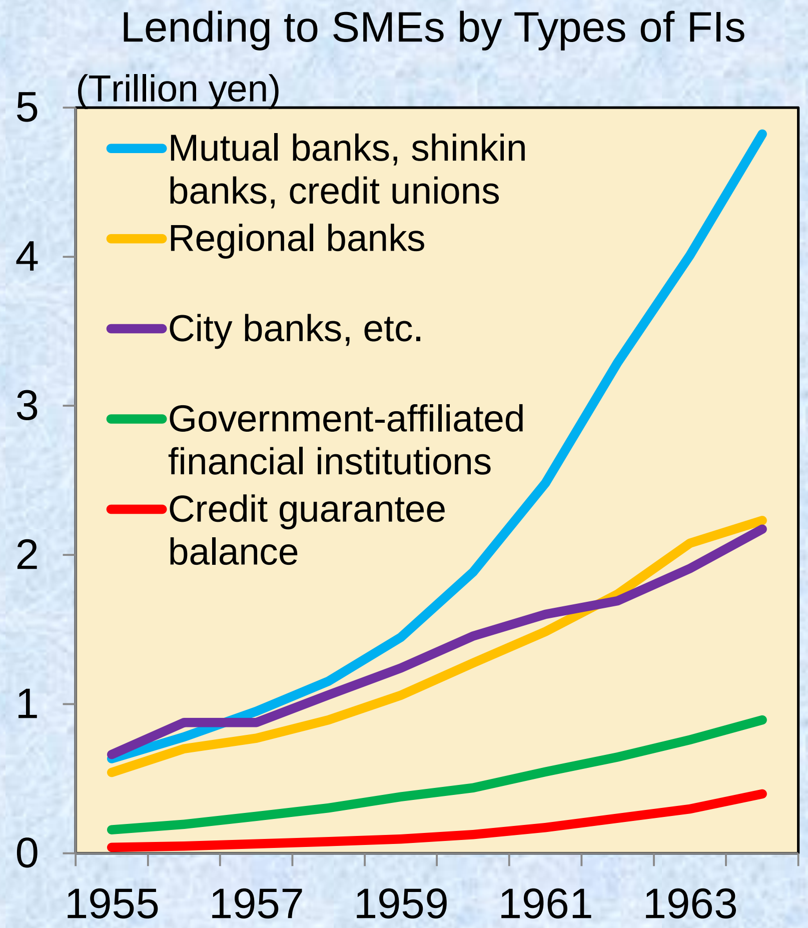
$$\text{The ratio of borrowings from the BoJ} = \frac{\text{Borrowings from the BoJ}}{\text{Real deposits + Bonds + Capital + Borrowings from the BoJ}}$$

# 2-3. Lending to SMEs during the High Economic Growth Period

This resulted in steady increase in the outstanding balances of lending to SMEs during the high economic growth period.

(Chart 3) SME Lending Balances

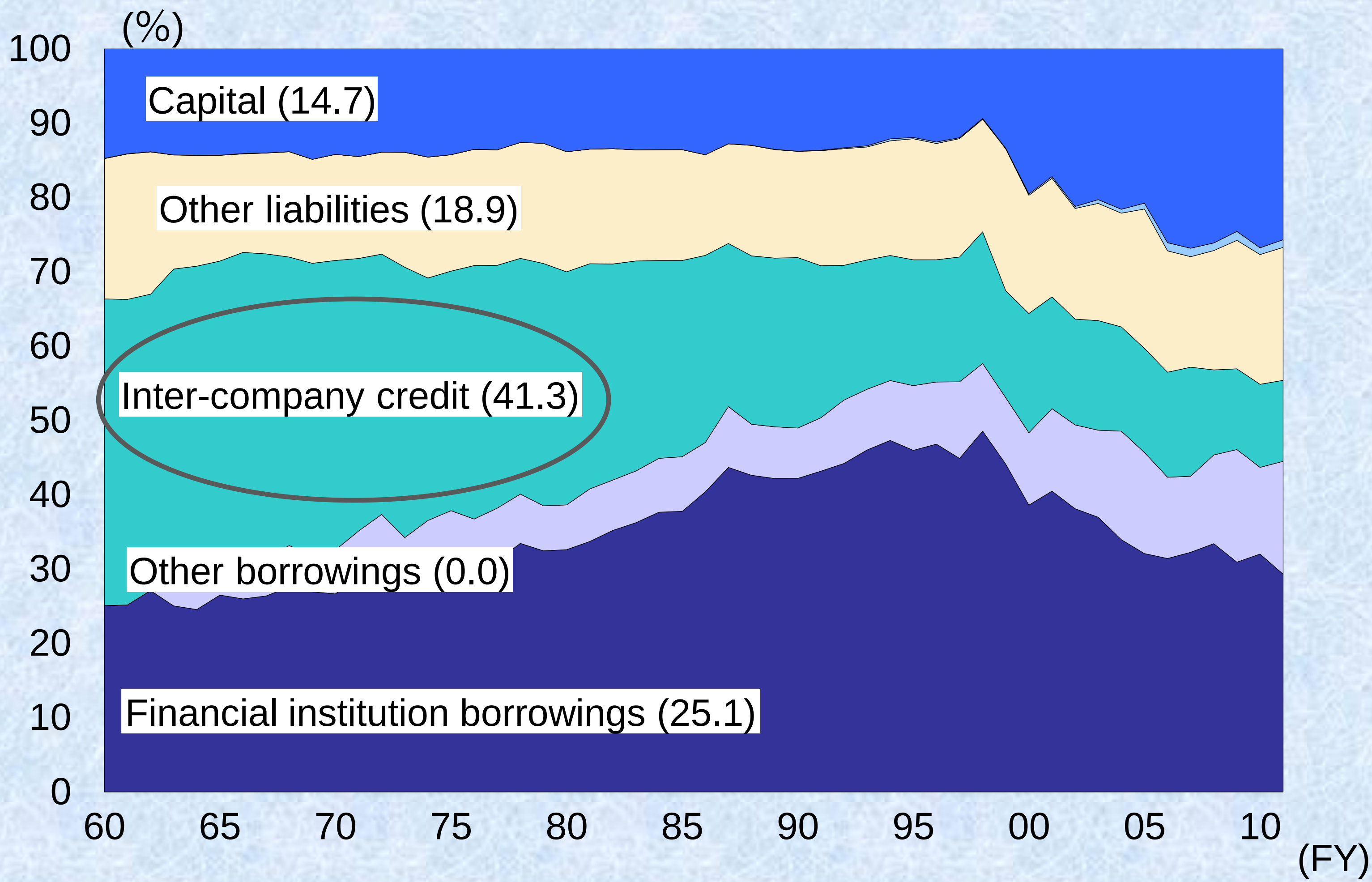


# 2-4. Development of Supply Chain Finance

Supply chain finance developed and played an important role in SMEs' funding.

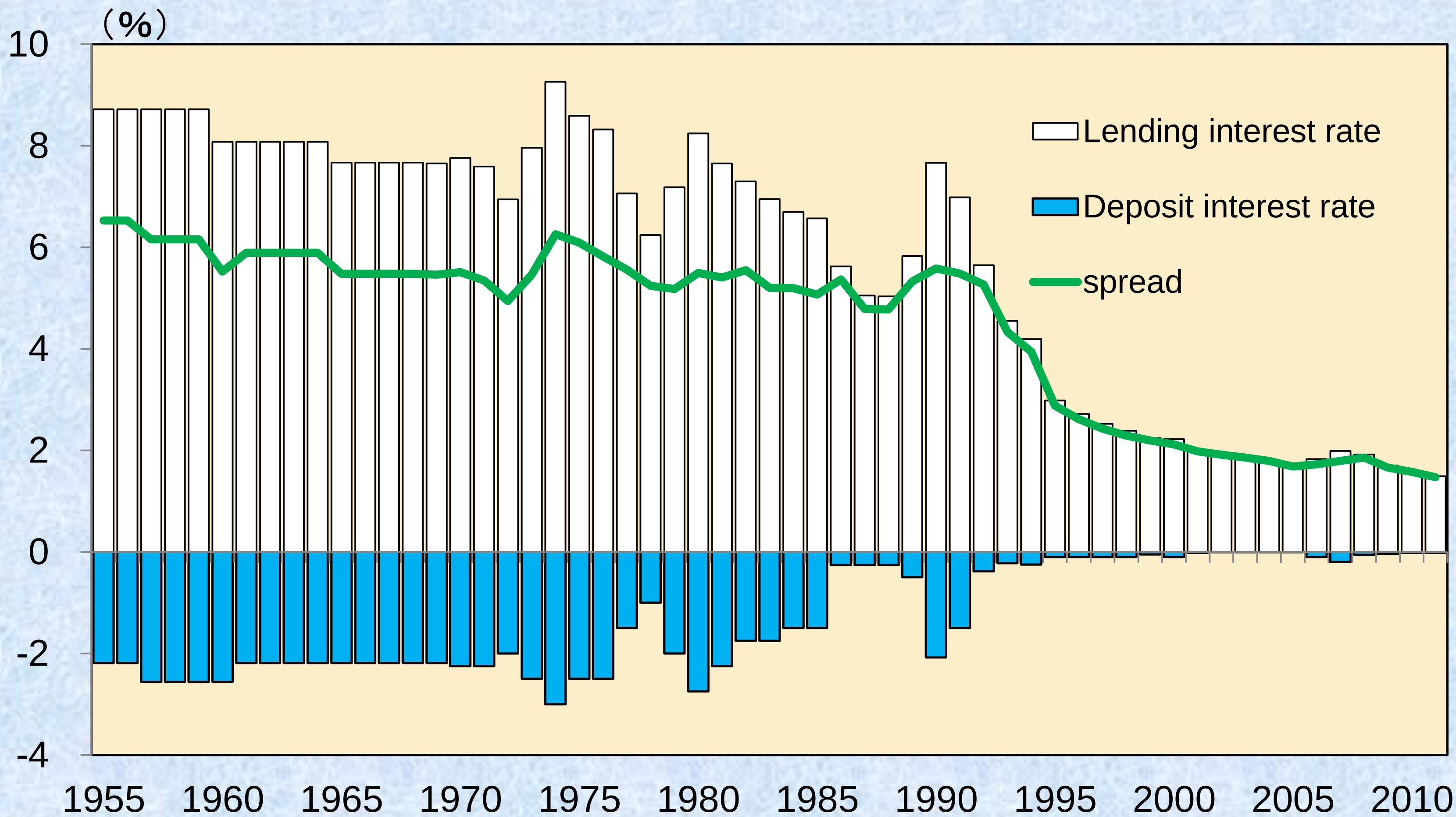
(Chart 4) SME Fund-Raising Structure



# 3-1. Current Issues: Intense Competition among Financial Institutions (1)

The abolition of deposit interest rate regulations (1985) led to smaller lending spread.

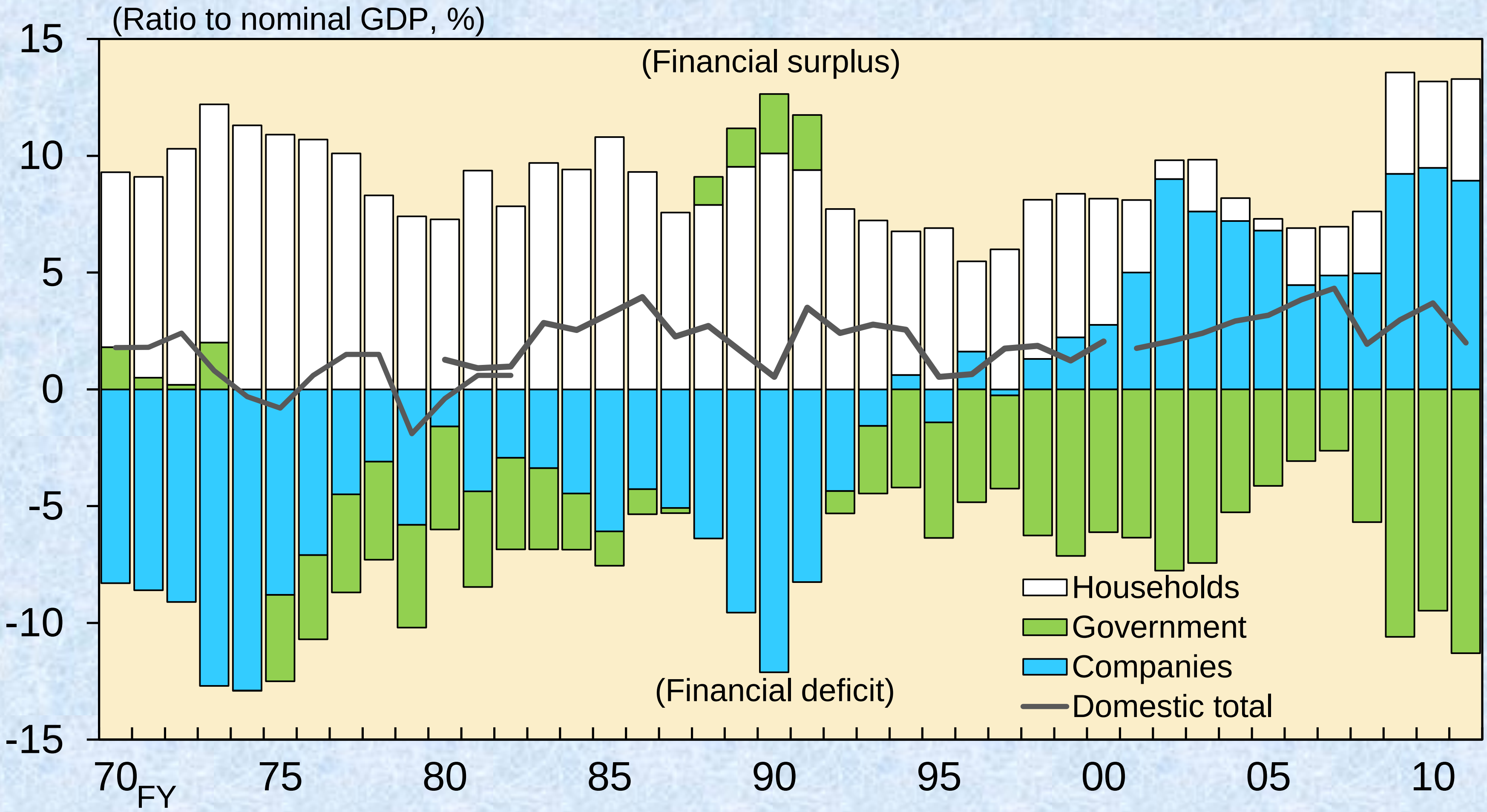
(Chart 1) Interest Rate Spread bet. Lending and Deposit<repeated>



# 3-1. Current Issues: Intense Competition among Financial Institutions (2)

Financial position of corporate sector turned to surplus during the low growth period.

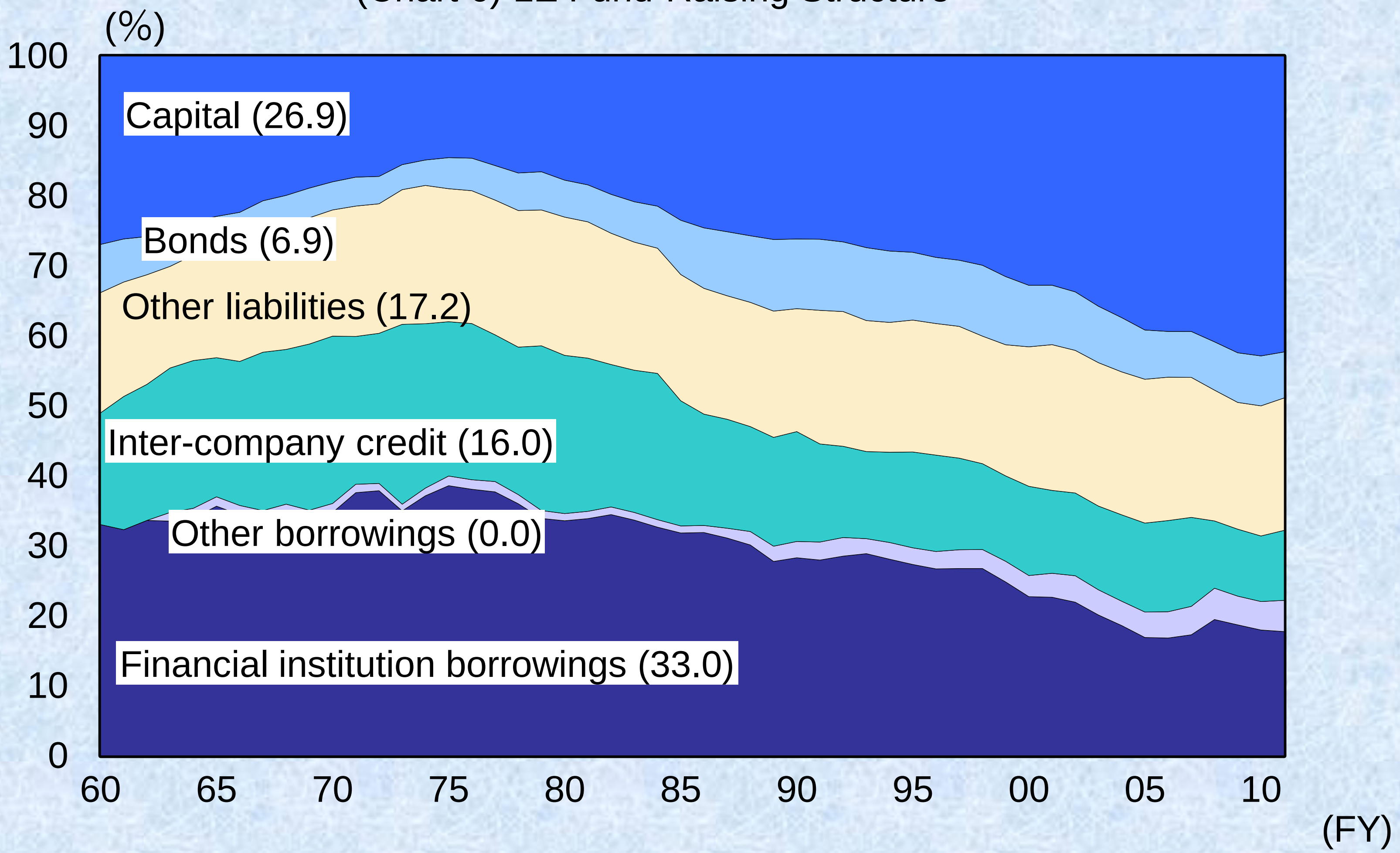
(Chart 5) Financial Positions of Main Sectors



# 3-1. Current Issues: Intense Competition among Financial Institutions (3)

Large enterprises have become less dependent on bank borrowings, as a result of the development of capital markets.

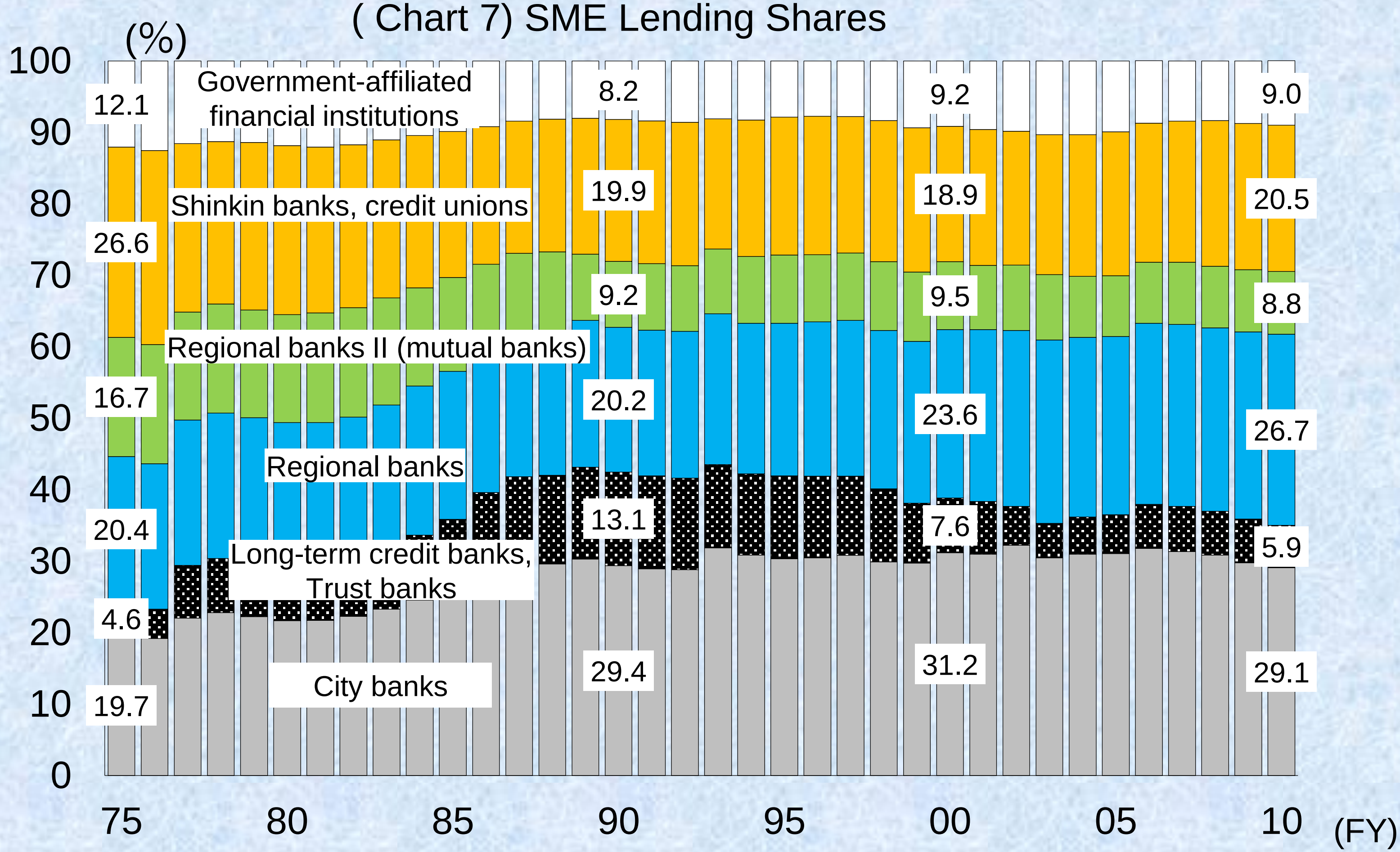
(Chart 6) LE Fund-Raising Structure



# 3-1. Current Issues: Intense Competition among Financial Institutions (4)

As a result, SME lending market has become more competitive. City banks and large regional banks increased their shares in the late 1980s.

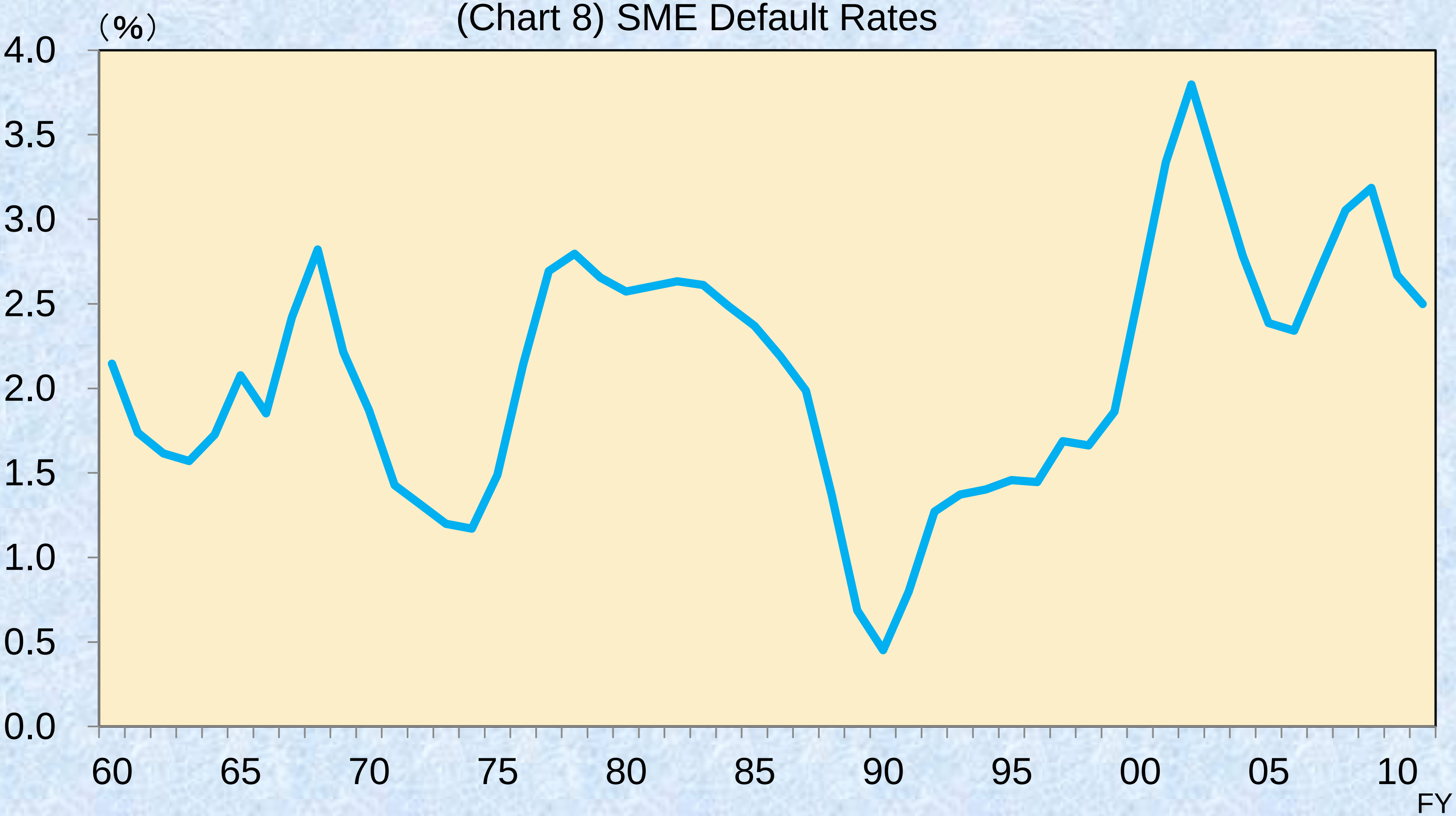
( Chart 7) SME Lending Shares



# 3-2. Current Issues: Increase in SME Defaults

SME default rates increased after the burst of economic-bubble. This also led to decrease in profitability of SME lending.

(Chart 8) SME Default Rates




Note: SME default rate = Credit guarantee corporations‘ subrogation ratio

# 3-3. Current Issue: Roles of Public Support in SME Finance

- Although private financial institutions hold sufficient amount of deposits to advance SME loans, government-affiliated financial institutions (GFIs) have generally maintained their direct, long-term concessional lending to SMEs.
- GFIs still play important roles in supporting temporarily troubled SMEs hit by economic crisis and/or newly founded SMEs with little credit records. However, even SMEs with high creditworthiness also make constant use of GFIs and credit guarantee corporations.

⇒ There are questions about the role of public sector in SME finance, from the viewpoints of both how to complement the private sector and how to prevent moral hazards.