Studies on a “New Bank” with the Primary Service Being Unsecured Loans to Japanese SMEs: -ShinGinko Tokyo, Limited-

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Studies on a "New Bank" with the Primary Service Being Unsecured Loans to Japanese SMEs: -ShinGinko Tokyo, Limited[1]-

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Introduction

ShinGinko Tokyo, Limited ("SGT", the meaning of *shinginko* is "New Bank") is a bank with the primary service of extending loans without collateral to middle-risk Small and Medium-sized Enterprises ("SMEs"[3]) using scoring model. The bank was established by the Tokyo Metropolitan Government ("TMG") under the initiative of Tokyo Governor Shintaro Ishihara, aiming to provide swift financing to cash-strapped SMEs, including those whose liabilities exceed their assets, as long as they have stable cash flows projected. The unique bank commenced the operations in April 2005 after obtaining approval from the Financial Services Agency ("FSA"), one of Japan's financial authorities. The TMG contributed capital to the bank fully[4].

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[3] Small and middle enterprises are defined by law as those manufacturing corporations which installed capital is less than JPY 300 million or the number of which employees is less than 300, as well as those manufacturing unincorporated enterprises (individually-owned companies), the number of which employees is less than 300. In case of the non-manufacturing, for instance, wholesale sector, they are defined as those corporations which installed capital is less than JPY 100 million or the number of which employees is less than 100.

[4] Japan Credit Rating Agency (JCR) has assigned a AA- and a J-1+ rating to senior debts and Commercial Paper (CP) program of the bank, respectively. A large amount of contribution from the TMG and the bank's close relationship with the local government underpin the rating.

In February 2004, the TMG announced “Master Plan for New Bank”, which provided a more concrete summary of the details of relevant operations at the SGT. The Master Plan suggested the mission of the new bank should create a reliable path to economic recovery and contribute to an environment that would enable such SMEs to demonstrate their full potential (TMG 2004). Interestingly the TMG encouraged the SGT to be a region-based *transaction* bank. Meanwhile, the FSA has been promoting region-based *relationship* banking, with a view to promoting, under a competitive environment, revitalization and activation of regional economies, facilitation of SME financing such as by encouraging new business in the region, and strengthening of management functions of regional financial institutions, thereby ultimately realizing active and vital regional societies (FSA 2004).

This paper aims to conduct a fact-finding on the SGT to assess how the new and unique challenge of financing to cash-strapped SMEs is processing.

Economic Realities and Backgrounds

First of all, we should see how the outstanding loans towards Japanese SMEs have recently dropped (see Table 1), in spite that the Japanese SMEs play the important role in the economy. It is worth noting that the Japanese SMEs’ share reached to 99% by the number of offices (Small and Medium Enterprise Agency or “SMEA” 2005) and to 72.6% by the number of employees (Ministry of Economy, Trade and Industry or “METI” 2005). In the manufacturing sector the SMEs’ share reached to around 50.5%, that is, around JPY 138 trillion in the overall industrial delivery / shipment with around JPY 274 trillion, and to around 56.8%, that is, around JPY 56 trillion in the overall value-added with around JPY 99 trillion (METI 2005).

Table 1: Changes in the outstanding loans towards small & middle enterprises (SME) and large enterprises (Large): Unit: JPY Trillion

	Dec. 1998	Dec. 1999	Dec. 2000	Dec. 2001	Dec. 2002	Dec. 2003	Dec.2004
SME	344.9	324.6	324.8	302.9	279.0	260.3	253.7
Large	146.3	154.2	131.1	124.9	118.2	106.6	97.5

Source: SMEA 2004, 2005

The outstanding loans towards Japanese SMEs have dropped sharply from JPY 345 trillion in December 1998 to JPY 260 trillion in December 2003, then to JPY 253.7 trillion in December 2004. Another survey by SMEA (2004) reports that in comparison with the outstanding balance of loans to SMEs in December 2000, the Japanese banks (excluding non-bank deposit-taking institutions such as credit cooperatives and credit associations) reduced it by 22.4 percent as of December 2003, then by 24.5 percent as of December 2004. Besides, more than 80 percent of the SMEs whose number of employees is less than 300 are required to provide their major line bank, "*main bank*", with the mortgage on their assets or the guarantee by Credit Guarantee Association (Governmental agency) for borrowing. Apparently, the Japanese banks' attitude to undertake the credit risk of SMEs has been very conservative and cautious.

As a cause of their conservative lending strategy, we can raise the non-performing loan problem they have accumulated after the bursting of the "bubble" economy and consequent financial stagnation during the 1990s, which have eroded their profitability. Not only incurred the non-performing loans heavy disposal expenses. But also that holding non-performing loans without disposing them would have incurred opportunity costs, that is, *transaction costs* for monitoring, because banks had to allocate labour and other managerial resources for dealing with the problematic non-performing loans. The erosion of profitability and an increase in transaction costs led to a downward pressure on banks' equity capital (net worth). A decline of the equity capital, which is a managerial buffer for banks' risk-taking, is considered to have lowered banks' ability to take risks, such as acquiring new customers and investing in new industries.

Table 2: Ratio of non-performing loans (NPL) to total asset and net profit/loss as of March 2005 in those Japanese regional banks into which public funds were injected.

Banks	Ratio of NPL (%)	Net profit/loss (JPY billion)
Ashikaga	12.5	118.4
Wakayama	12.4	0.8
Momiji HD	11.8	1.6
Kanto Tsukuba	10.9	-4.9
Kyushu Shinwa HD	10.8	-21
Yachiyo	9.6	4.9
Kumamoto Family	9.2	5.1
Ryukyu	7.7	6
Gifu	7.3	1.9
Hokuhoku FG	7.1	11.2
Nishi-Nihon City	6.5	14.5
Chiba Kogyo	6.1	4.5
Higashi-Nihon	5.5	5.8

Source: Nikkei Newspaper on 10 June 2005

While major city banks, in particular, Japanese “mega-banks” have recently accelerated to write off their non-performing loans, the Japanese regional banks still suffer a high level of ratio of non-performing loans to total asset at 5.51% on average among 87 regional banks as of March 2005 (reported by Nikkei Newspaper on 10 June 2005). The ratio is hit at over 10% in some regional banks (Table 2). According to SMEA (2004), 57% of those SMEs with 0 to 20 employees depend their funding on regional banks as their “main banks”, while 23% on city banks. Meanwhile, 57% of those SMEs with 21 to 100 employees depend on regional banks, while 28% on city banks.

Cabinet Office (2001) and SMEA (2004, 2005) are worried that the decline in banks’ risk-taking capacity would lead to a restraint on corporate business investment through banks’ cautious lending activities. In particular, they are worried that it has a large impact on small and medium-sized enterprises that do not have major funding sources other than bank borrowing. Cabinet Office (2001) points out that the there was a fairly tangible “credit crunch” during the 1997-1998 period, when banks’ lending attitude became suddenly severe and loans to small and medium-sized enterprises decreased. It shows an estimation by a group of scholars that a decrease in business investment caused by the deterioration of lending attitude lowered GDP growth rate by about 1.3% in 1998 (Cabinet Office 2001; p.96).

As was mentioned earlier, the Japanese SMEs play the important role in the economy. According to SMEA (2004), an examination of the rate of growth in “total factor productivity” in present-day Japanese manufacturing by size reveals that growth is on average higher at SMEs than large enterprises. The survey reports that the rate of growth in total factor productivity[5] of SMEs (with 50-300 workers) was 1.14% on average annual growth from 1995 to 2001, while that of large enterprises (with 301 or more workers) was 0.88%. As a result, SMEA (2004) reports that SMEs are playing an active role in technological progress and other forms of technological innovation. Nagahama (2002) conducts a survey of estimating the percentage of the SME’s contribution to the change in the composition of value-added by industry and by size of firms. According to the survey, the SME’s contributed no less than 75% to the change in the 1990s after the bursting of the bubble economy.

To ensure the supply of sufficient financial resources to those innovative SMEs, most of which have little access to securities market for their funding, is the significance for the Japanese economy and would be a key point for revitalizing it. At the same time, innovative

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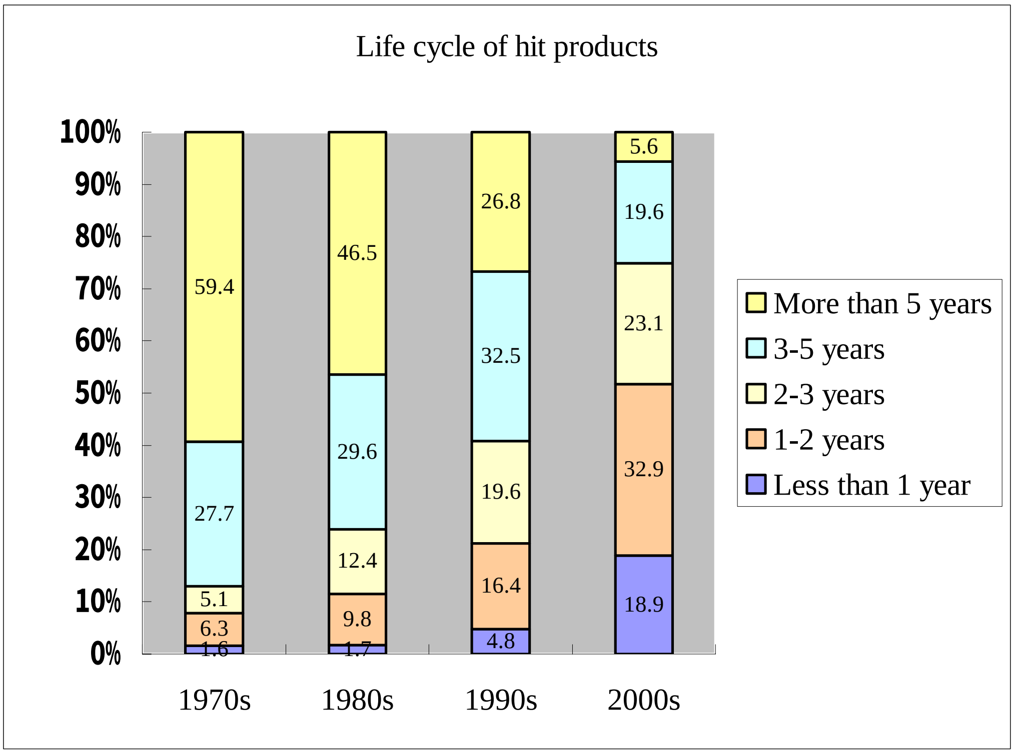
[5] Rate of growth in total factor productivity (TFP) = rate of growth in value added - labour’s share x rate of growth in number of workers - capital’s share x rate of increase in tangible fixed assets.

SMEs are exposed to a severe competition and their future is subject to fundamental uncertainty.



Created by the author upon SMEA (2005)

Figure 1: Life cycle of hit products

SMEA (2005) reports an interview / hearing based research in which the life cycle of SMEs' hit products (hot selling products / products of marketable goods) has been shortened (Figure 1). This report shows that although the life cycle of about 60% of hit products lasted more than 5 years in the 1970s, the percentage of hit products that can be marketable more than 5 years has radically dropped to only about 5.6% in the 2000s. Recently, the life cycle of more than 50% of hit products has been shortened to "1 to 2 years" or "less than 1 year". Apparently, the firms have been exposed to higher business risk associated with developed products obsolescence. Products obsolescence is due partly to the change and diversification in consumers' taste. But, this is due mainly to a severer competition in which rival firms can accelerate their competitive products to market. Under the competition, the firms have been exposed to higher business risk of the potential failure to get the sufficient return on investment. That is, their probability of success has been exposed to intensified uncertainty.

Japan's financial authority considers that Japan's financial system is entering a new forward-looking phase aiming at establishing a desirable financial system for the future, having now moved beyond the emergency reaction against the non-performing loans problem. This new phase is described as one in which the regular's attitude changes from an emphasis on "financial system stability" to an emphasis on "financial system vitality" (FSA 2004). Taking the changes in phase from "stability" to "vitality" into consideration, facilitation of SME financing by encouraging new business should be outweighed, with a view to promoting, under a competitive environment, revitalization and activation of overall economies.

History and Positioning of SGT

The TMG announced "Mater Plan for New Bank" in February 2004, for the purpose of providing "a more concrete summary of the details of relevant operations, as well as guidelines for administrative operations at the New Bank"(TMG 2004). The Plan refers to the purpose of establishing Shin-Ginko Tokyo (SGT) as "in the midst of serious conditions being faced by SMEs, to create a reliable path to economic recovery and contribute to an environment that will enable such SMEs to demonstrate their full potential"(*ibid*.).

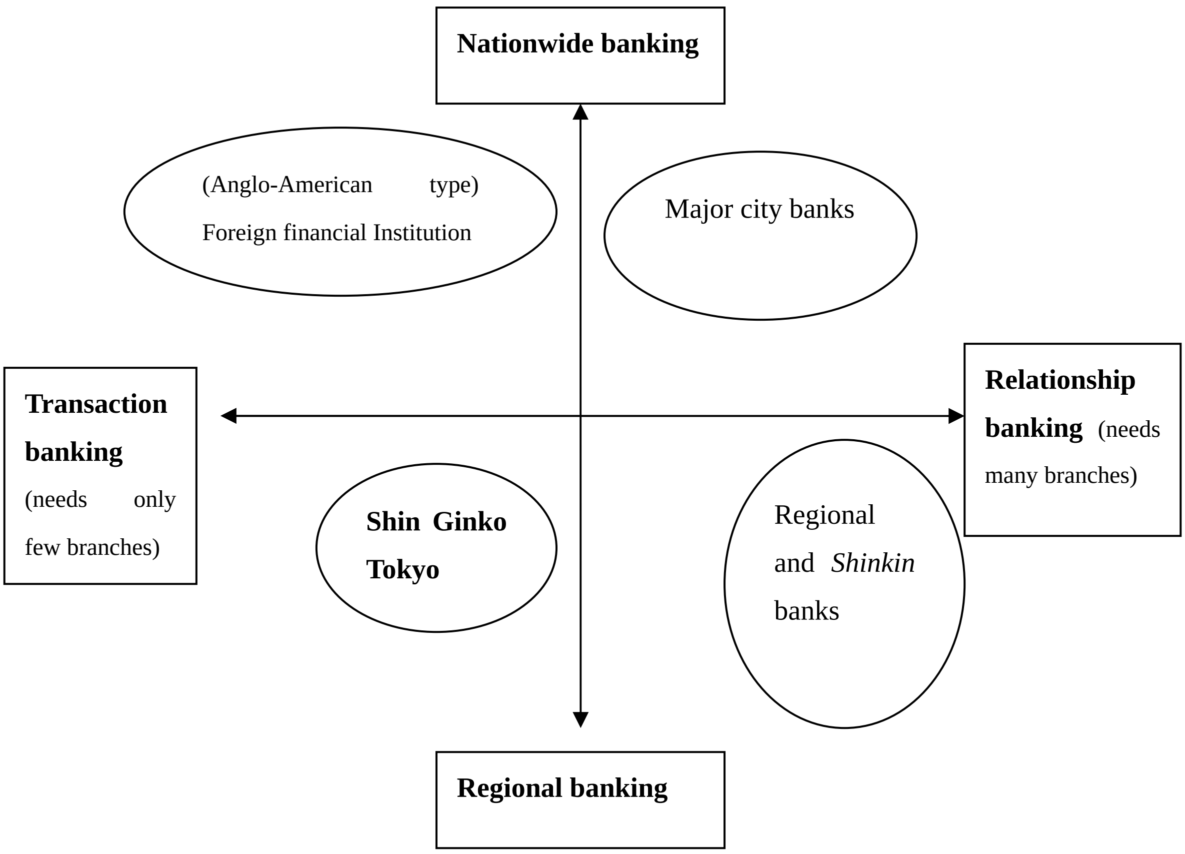


Figure 2: Positioning of SGT (Source: TMG 2004)

SGT is expected to play a role in complementing small business policy implemented by TMG. At the same time, the Plan refers to the unique positioning of SGT as a new “regional and transaction bank” which would not target to expand its business nationwide like as major city banks, but focus on regional banking in Tokyo Metropolitan, with Anglo-American type “arm’s length” banking practices and governance. The Plan explains the unique positioning of the new bank using Figure 2.

The horizontal axis in Figure 2 shows the nature of banking practices such as “transaction banking” and “relationship banking” whereas in the vertical axis the focus of the banks, regional or nationwide is shown. It is natural tendency in Japan that mega *city* banks operate nationwide with many branches spreading almost all regions. In contrast, *regional* banks and *Shinkin* banks are perceived to serve the financing needs of specific region and naturally they operate extending less branch network than do mega city banks. Moreover, they care about nurturing bank-client relationship which provides them a competitive edge of business for keeping screening and monitoring costs minimum. Since the purview of business of those banks is smaller because of concentrated regional focus, they are assume to well cater the needs of small and medium size industries and thus facilitate segregating good borrowers form the bad.

Banking system in Japan is typically characterized as “relationship banking” which implies that bank-client relationship is said to play crucial role for attenuating the asymmetry of information between them and for reducing the screening and monitoring cost in banks as lenders. This system of banking practice differs from that of Anglo-American type banking system where consideration for screening and extending loans is influenced by short term gains and arm’s length relationship and selection criterion is dominated by a codified method of statistically expected default frequency. Scoring or credit rating reflecting clients’ financial statements is a fundamental building block for undertaking any lending activities by banks. Thus, the system is characterized as “transaction-based” “arm’s length” banking. However, it is not unusual that some banks in the Japanese-German type banking system are more comfortable with transaction based business than building traditional bank-client relations. Based on this assumption, positioning of typical Japanese city and regional banks is depicted in the Figure respectively.

Anglo-American type financial institutions are also present in a very handsome number for feeding up various financing needs of both foreign and domestic firms. They basically are located on several big cities where business activities are taking place in a larger scale. Even though they are very selective in expanding branches, and business activities are limited to small scale, services are open to customers both from national and regional levels. They basically opt to serve “whole-sale” or “transaction-based” type financial products using skills and technique of quantifying various risks. Obviously, they are away from building long-term bank-client relationship exemplified with typical Japanese banks.

From this perspective, the establishment of SGT is a unique case because its business strategy is driven away from typical banking tradition of relationship-banking embedded in the Japanese financial system. With branch network centred only in Tokyo Metropolitan, the bank is intended to conform to the arm's length or transaction based banking practices. This marks a sharp question on how far the strategic view of SGT will be able to make it viable even breaking the long lasting banking tradition in Japan. While the national planning is to "promote region-based relationship banking" for revitalizing and enhancing competitiveness of SMEs, SGT's move counters to the broad based national planning rather construes a seemingly bold endeavour, the success of which will undoubtedly promote a new dimension of banking industry in Japan.

SGT was established in April 2004 and its operation was started in April 2005 with a start-up capitalization of 100 billion yen. SGT had initially planned to raise by March 2006 around 50 billion yen in additional capital from private businesses, of which it has already secured 18.7 billion yen from 37 firms, including NTT Communications Corporation and Hitachi Limited which contributed 2.5 billion yen respectively via private placement of shares at the end of August 2005, while Aioi Insurance Co. invested 2 billion yen. Now the major shareholders of SGT are as follows (Table 3);

Table 3: List of shareholders in SGT (as of December 2006)

Name of shareholders	Amount (billion yen)
Tokyo Metropolitan Government	99.8**
NTT Communications	2.5
Hitachi Limited	2
Aioi Insurance Co.	2
Shinkin Central Bank	1.15
Orix	1
Kashima Construction	1
Taisei Construction	1
Nikko Cordial Group	1
Mistui-Sumitomo Marine Insurance	1

**The number of shares is 4,991,207 (Source: SGT website)

A Framework of Explaining the Strategy of SGT

A particular firm's credit ratings and statistical expected default frequency (EDF) for its credit category allow us roughly to estimate a range of expected interest-rate margins, in which the firm would be able to raise funds in the market. We can then draw the *required margin curve*—the relation of the expected spread to the credit ranking of each borrower as Figure 3 illustrates (see also Suzuki 2005; pp.70-72).

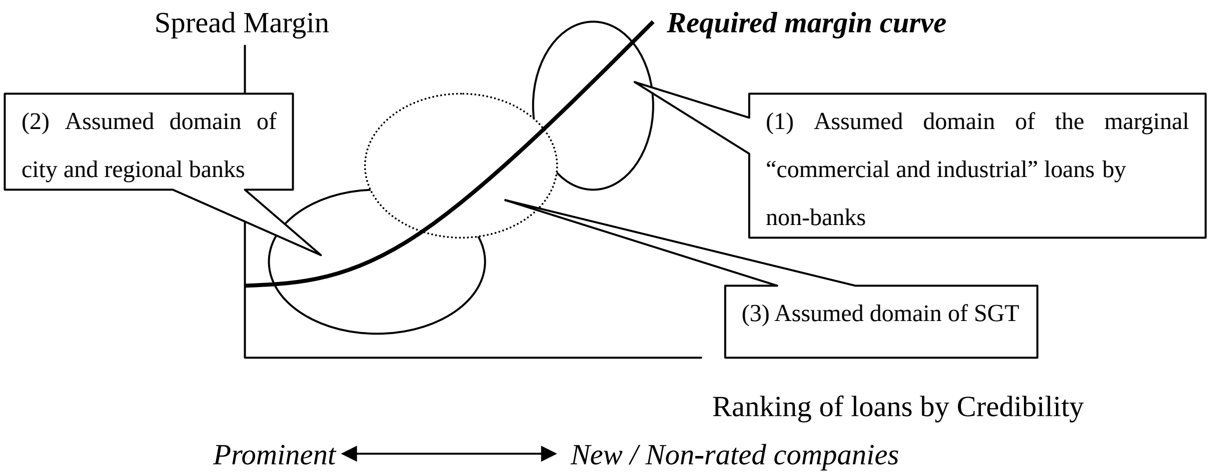


Figure 3: Required margin curve and conceptual assumed domains

In the loan (debt) market, borrowers are required to keep a certain level of credibility. If they fail to keep it, very few sources of funds in the form of loans are available. In Japan there exists the so-called "Commercial and Industrial Loan" as a marginal funding source. Some firms with lower credibility have no choice but to borrow the loan, the interest rate of which is even very high, around 15% p.a.. The conceptual domain of the commercial and industrial loan provider is assumed as the circle (1) in Figure 3. In contast, the conventional loan providers such as "city banks" and "regional banks"are living in the conceptual domain (2) in Figure 3, where they prefer to extend softer loans (the interest rate condition is around 1 to 5 % p.a.) to prominent large and middle-sized firms with higher credibility. The targetted domain of SGT is considered the dotted circle (3) in Figure 3, a lacuna which is not fully coverred by eigher commecial & industrial loan providers or conventional loan ones. SGT estimates the market size of the lacuna at several trillion yen[6].

SGT prepares the following financial products of providing swift financing to SMEs; (1)

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[6] From an interview with an Executive Officer of SGT on 23 August, 2006.

Portfolio Financing (“PF”) and (2) Financing Emphasizing Technical Capabilities and Future Potential (“FETCFP”).

Table 4: Features and conditions of financial products prepared by SGT

	(1) PF	**(2) FECTFP**
i) Features	a) Swift screening and answering within 3 business days to loan applications. b) Automated screening process based on a scoring model putting importance on clients’ cash flows. c) Efficient operation by centralization of transactions. d) Disclosure of screening process.	a) Financing to challenging but financially troubled SMEs with a certain level of technical capacities and future potential. b) Making use of the skills and know-how of providing unsecured loans and guarantees to SMEs, held by collaborated companies and consulting firms. c) Supporting clients by issuing “certificate of technical capacities and future potential” for enhancing their credibility.
ii) Eligibility	SMEs even though they are falling in negative worth.	Periodically accepting loan applications through collaborated financial institutions and organizations.
iii) Final Maturity / Tenor	5 years (7 years in case of secured loans)	3 years (5 years in case of secured loans)
iv) Interest	In principle, 2 to 8 percent in accordance with credit risks.	In principle, 2 to 8 percent in accordance with credit risks.
v) Loan amount	Up to ¥ 50 million	Up to ¥ 100 million
vi) Security conditions	In principle, unsecured condition (no mortgage, no guarantee)	In principle, unsecured condition (no mortgage, no guarantee)

Created by the author based on TMG 2004 and SGT website

The automated screening process [(b) of (i) in Table 4] in the PF, according to SGT (an interview with an Executive Officer of SGT on 23 August, 2006), refers basically to its scoring upon the last two years’ financial statements of clients. At the same time, it also refers to additional qualitative information on clients to be collected with some transaction costs. Based upon the scoring upon quantitative data as well as the additional qualitative information, SGT undertakes credit risks of clients including those who are falling into negative worth. Besides, the screening process includes the cash flow analysis by confirming the contracts received by clients, and also refers to checking the personal credit information on CEO as well as the flows and balance in clients' account in their main line banks. At the point in the interview on August 2006, the average final maturity [(iii) in Table 4] in the PF is around 3.5 years and the average interest rate (iv) is around 6.5 percent.

Basically, SGT is not so aggressive for providing loans to "start-ups". In fact, the eligibility for their PF is limited to the firms having at least two years' settlements of accounting. As of August 2006, no transaction in the FETCFP scheme for providing loans to start-ups had been made.

Overview of Financial Statements

In the first financial statement as of March 2006 (from April 2005 to March 2006), SGT recorded the net loss of ¥ 12.3 billion (¥ 123 Oku-yen) from ordinary business operation and the final net loss of ¥20.9 billion (Table 5). Since their full operation was started in July 2005, the outstanding balance of loans and guarantees stayed at around three-fourths of the initial plan.

Table 5：Overview of SGT's financial statements as of June 2006

Unit: 100 million yen (Oku-yen)

	March 2006 (result)	*March 2006 (Plan)*	*March 2007 (Plan)*
Revenue	36	60	130
Gross profit	20	53	n.a.
Expenses	144	151	n.a.
Net profit from ordinary business operation	-123	-98	n.a.
Cost for writing off NPLs	85	121	n.a.
Current net profit	-209	-219	-180
Net profit/loss	-209	-219	-180
Outstanding balance of deposits	3,201	2,870	4,800
The number of deposit accounts (unit: 10,000)	4.9	10	30
Outstanding balance of loans and guarantees	1,930	2,580	4,300
Outstanding balance of NPLs	17	n.a.	n.a.
Equity capital ratio (%)	30.31	n.a.	n.a.

Source: Nikkei newspaper on 2 June, 2006 and others

The initial investment in developing infrastructure for operations, such as information system and call-centre facility led to the negative earnings. However, because the cost for writing off NPLs (according to SGT, their NPLs are finally sold in bulk to loan servicers) was not so necessary than expected in the plan, the final deficit was within the budget in the plan.

The outstanding balance of loans and guarantees as of the end of March 2006 stayed at ¥ 193 billion, 74.5% of the targeted level in the plan. In particular, according to a media (Nikkei Newspaper), the outstanding of loans to SMEs stayed at ¥ 103.2 billion, only 56% of the targeted level in the plan. Besides their operation in providing loans and guarantees has not reached to the targeted level, offering higher deposit rate to attract more depositors presumably hampered the gross profit, below 40% of the target level in the plan.

It is worth noting that the outstanding balance of loans and guarantees as of the end of December 2005 stayed at ¥ 88.9 billion, 34% of the target level (Nikkei on 1 February, 2006). This indicates that SGT increased the loans and guarantees aggressively by ¥ 104.1 billion during January and March 2006. However, among the loans and guarantees increased during the period, only ¥ 32.4 billion was allocated as unsecured loans to SMEs, while the rest to leading medium-sized enterprises with lower credit risks. According to an executive officer of SGT, during the period, SGT aggressively participated in the syndicated loans to prominent and leading medium-sized enterprises and purchased the “secured” loans backed by account receivables or mortgages.

Concluding Comments

As of September 2006, SGT recorded the current income (revenue) of ¥ 4.7 billion including the interest income of ¥ 3.5 billion, while paid the expenses of ¥ 20.1 billion including the reserve for loan losses of ¥ 9.9 billion, resulting in the net loss of ¥ 15.4 billion. Meanwhile, the outstanding balance of loans and guarantees stayed at ¥ 281.9 billion. SGT is required to pursue for scales of economy in their loan business and to improve spread margins with proper risk-raking.

Recently major city banks (*mega*-banks) have been more aggressive to penetrate into the loan market towards SMEs, having overcome their lingering NPLs problem. Severer competition with mega-banks urges SGT to its marketing strategy. According to SGT (from an interview in August 2006), *Mizuho* bank and *Mitsubishi-Tokyo-UFJ* bank expanded their marketing to the small enterprises with the annual sales of ¥ 500 million, while *Sumitomo-Mitsui* Banking Corp. did to those with the annual sales of ¥ 300 million. Accordingly, SGT changed their marketing target to the small enterprises with the annual sales of below ¥ 500 million. It might be too early to judge whether the unique business model of SGT as “regional” and “transaction” bank will be successful. At least, SGT faces difficulty of finding and maintaining its “reason d’etre” in the market.

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