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Abstract

In June 2017, the Japanese Diet passed "the Act on the Partial Revision of the Small and Medium-sized Enterprise Credit Insurance Act to Promote Improvements and Developments of SME's Business Management" (Credit Guarantee System Reform Act in short) in order to enhance the roles that credit-guarantee system plays in terms of supporting SMEs. In this paper, the author, who was a member of the Small and Medium Enterprise Policy-Making Council's Financial Working Group (the Financial WG), tries to explain what this reform aims.

Key Words

Credit Guarantee, SMEs, Bank, Government Support, Japan

[#] Needless to say, this paper consists of the author's personal opinions and interpretations, and is not intended to represent the positions of the Small and Medium Enterprise Policy-Making Council's Financial Working Group (the Financial WG) or the Small and Medium Enterprise Agency of the Japanese Government.

1. Introduction

In June 2017, the Japanese Diet passed “the Act on the Partial Revision of the Small and Medium-sized Enterprise Credit Insurance Act to Promote Improvements and Developments of SME's Business Management” in order to reform the credit-guarantee system. The author was a member of the Small and Medium Enterprise Policy-Making Council's Financial Working Group (the Financial WG). The Financial WG prepared “the Report to Establish a Sustainable Credit Enhancement System to Support the Development of Business of SMEs and Small Enterprises," which served as the foundation of the reform act. As I participated in deliberations, I have high hopes for various developments in line with the reform act and the enrichment of support for small and medium-sized enterprises (SMEs).

For these hopes to be met, it is essential to have an accurate understanding of what the reform act requires the credit guarantee associations. This paper, based on the Financial WG report, discusses the new functions that credit guarantee associations are expected to provide and the issues faced in addressing those challenges.

2. What Issues Did the Financial WG of the Small and Medium Enterprise Policy-Making Council Try to Solve?

In *the Japan Revitalization Strategy 2015* (June 2015), the Small and Medium Enterprise Agency was asked to "deliberate regarding credit-guarantee system’s developments to promote further active support by financial institutions to SMEs that undertake management reforms and productivity improvements." Following the directions of the Japan Revitalization Strategy, the Financial WG was established within the Small and Medium Enterprise Policy Making Council, and began deliberations in November 2015.

As pointed out by the Japan Revitalization Strategy, the main reason why this deliberation started was a concern that the credit guarantees were so generous that they were presenting an impediment to the support incentives of financial institutions. As the launch point of these deliberations was the Japan Revitalization Strategy, it is clear that the focus of the discussions was how to transform the credit-guarantee system to enrich the support offered to SMEs by financial institutions. In other words, the main purpose was not how to contract the role of the credit-guarantee system, nor how to reduce its fiscal burden.

For example, following the collapse of Lehman Brothers, the increase in the number of companies with relaxation of terms for loan repayment was unavoidable, but normally companies would be expected to implement management improvements with support from financial institutions and extricate themselves from these tough circumstances within a few years. However, according to data from the Small and Medium Enterprise Agency, although the number of companies with relaxation of terms for loan repayment has decreased slightly, the rate of decrease has been unexpectedly slow. Some argued that this was because financial institutions were no longer providing sufficient support as the result of the robust protections provided under the Emergency Guarantees[1].

3. What Did the Financial WG Propose to Enhance Functions of Credit Guarantee Associations?

Through over a year of deliberations, in December 2016, the Financial WG issued a report titled, "Establishing a Sustainable Credit Enhancement System to Support the Development of Business of SMEs and Small Enterprises." The "Support the Development of Business" portion of the title reflected the Financial WG's members' hopes for reforms.

The introduction of the Financial WG report stated, "It is important to provide sufficient credit through the credit enhancement system." The report pointed out the importance of the credit-guarantee system for SME financing, and stated that the objective of the report was to deliberate regarding policies for "promoting the business development of SMEs and contributing to greater productivity and regional revitalization while minimizing side effects." This indicates that the key to these guarantee system reforms was the enhancement of functions for providing support to SMEs, and that it was expected that credit guarantee associations would play major roles in providing this support.

Based on the "efforts based on life stages" and "guarantee association operation" in the report, this

[1] When the loans guaranteed under the Emergency Guarantees become uncollectible, banks extending the loans can receive 100% compensation from credit guarantee associations and therefore suffer no losses.

section explains specifically what the report expects with regard to enhancements of credit guarantee associations’ function.

(1) Securing of conventional loans

As discussed above, the major objective of this reform was to promote the provision of support by financial institutions, led by main banks, for SMEs that had been left unchanged, without implementing management improvements. In the words of the report, its goal was for financial institution activity which would "provide financing based on evaluations of business, without excess reliance on credit guarantees, appropriately provide follow-up management and business support during the financing period, resolve problems while communicating with enterprise operators, and promote the development of business."

Initially, the Financial WG considered uniform reductions to guarantee ratios depending on individual firms’ life stages. However, through interviews with financial institutions, the Financial WG found that bank branch managers didn’t focus on the difference between 100% guarantees and 80% guarantees. Therefore, we concluded that the current sharing of responsibility did not produce significant differences in terms of fostering support incentives at bank branches. This suggests that to change the behaviors of branch managers of financial institutions, significant reduction of guarantee ratios would be necessary, but this would greatly increase the likelihood that they would not serve as safety nets when the SMEs really need governmental supports (e.g., the Lehman Crisis). Also, there were concerns that mechanically deciding guarantee ratios based on life stage, etc., would frequently result in incompatibility with the actual management conditions of SMEs, which are highly unique, and therefore deteriorate the quality of credit guarantee-based SME support.

The report therefore recommended prioritizing the securing of conventional loans (i.e., bank loans without public credit guarantees), stating, "Noting the conditions and trends of credit transactions, including past loans by financial institutions, operation condition assessment and understanding of business viability, such as the effects of recent loans of funds, and support efforts such as policies for providing loans in the future, it would be effective to flexibly allocate risk burdens between credit guarantee associations and financial institutions based on the actual conditions of individual SMEs." It also called for the ratio of conventional loans to be "flexibly adjusted based on the actual conditions of individual SMEs." For example, even companies that have seen steady growth in sales and are still in their growth and development phase may experience a sudden downturn in sales due to some factor, and be unable to secure a conventional loan from a financial institution. Mechanically setting credit guarantee ratios might result in financial institutions cutting off funding, but using a system in which ratios are flexibly set would make it possible to handle such situations by, for example, increasing the amount of loans with guarantees when necessary.

In order to achieve an appropriate balance of risk bearings, credit guarantee associations are expected to play new roles when receiving requests for guarantees from private financial institutions. That is, until now it was enough for the associations to assess the repayment capabilities of the loan recipient. In the future, however, they must also take the support stance of private financial institutions into consideration, and they are expected to include the financial institutions' support attitude in their guarantee approval conditions. In particular, credit guarantee associations are hoped to review and revise their application processes and evaluate whether applications for usage of guarantees only increase the amount loaned, without helping to improve the productivity of companies taking out loans.

Going a step further, appropriate risk allocation is not just a function exercised during the guarantee use application process. In the future, there is a need for continuous monitoring of whether private financial institutions are continuing to provide conventional loans and appropriate support for companies receiving guarantees. For example, it is essential to avoid situations in which conventional loans that existed when guarantees were applied for are paid off at some point, and main bank support stances crumble.

The flexible system proposed by the report, if implemented properly, would be extremely effective, but great problems could occur if it is not implemented properly. The deciding factor behind the success or failure of this new system is the competence of individual credit guarantee associations. If a credit guarantee association were a bad doctor, it would continue to prescribe medicine for patients that weren't sick, and fail to prescribe medicine in a timely fashion to patients who truly needed it. It would be a great failure indeed if mechanical rules turned out to be the better alternative.

(2) Enhancement of credit guarantee association functions

In the section on credit guarantee association operation efforts, the report states, "guarantee association operations have traditionally been focused on guarantees and reclamation, but with the changing environments the roles required of them are also changing." The report confirms that roles of credit guarantee associations have changed to meet the changing demands of the times, and further states, "their support efforts have been strengthened in terms of management improvements in response to the sudden increase of companies with relaxation of terms of loan repayments as the result of the financial crisis prompted by the 2008 collapse of Lehman Brothers, and credit guarantee associations have prepared objective and fair operation systems." It is evident that the report positively evaluates the recent efforts of and handling by credit guarantee associations.

The report goes on to provide recommendations for further function enhancements, so I will explain in line with the report's recommendations.

(i) Appropriate risk allocation between credit guarantee associations and financial institutions

As mentioned in the preceding section, the goals of the current reforms are "to promote support by financial institutions by implementing risk allocation through the appropriate combining of credit guarantee-backed loans and conventional loans based on the business conditions of SMEs."

It is important to note that "when handling with SMEs whose business conditions are deteriorating, credit guarantee associations must take into sufficient consideration the support stances of financial institutions." Credit guarantee associations must "handle" cases based on "sufficient consideration of the support stances of financial institutions." In order for this to be effective, it is essential that credit guarantee associations and private financial institutions deepen their mutual understanding through day-to-day communication. Credit guarantee associations may also vary their handling methods based on the stances of financial institutions, such as streamlining association’s screening processes or prioritizing the handling of preferred credit products for outstanding financial institutions.

The report also states, "When a main bank cannot provide sufficient funding, it is also important to enhance the consultation scheme between credit guarantee associations and SME support institutions, such as having credit guarantee associations provide introductions to other financial institutions, or having SME support institutions promptly connect with credit guarantee associations when they are asked from SMEs a help regarding financing." Performing these functions is expected to ensure that credit guarantee associations work as safety nets in terms of support. What credit guarantee associations can do on their own is limited, so it is important that they build close relationships to realize effective coordination with outside support institutions. Fortunately, all credit guarantee associations have past experience as the secretariat of the SME support network, so there are high hopes that they will further develop their functions based on this experience.

(ii) Promotion of management support and business turnaround

Credit guarantee associations have implemented various management improvement measures in the past. They will be required to implement yet more measures in the future. For example, one of the problems frequently encountered with corporate turnaround is that multiple financial institutions are involved, so coordination between creditors stalls, time passes without progress being made, and support is therefore delayed. When these difficulties with coordination between creditors occur, credit guarantee associations can be effective in resolving them by acting as secretariats in bank meetings (management support meetings), and by further enhancing and enriching the support they offer. Furthermore, with regard to situations in which main banks do not sufficiently respond to issues, the report recommends that "credit guarantee associations actively handle situations, for example by dispatching experts at their own discretion."

Regarding business turnaround, the report also recommends that they "flexibly abandon the right to reimbursement in order to implement turnaround plans in a timely fashion while taking individual conditions into consideration," and that, with regard to the reclamation operations of credit guarantee associations, they "should make the perspective of renewed efforts by enterprise operators into consideration and take appropriate actions."

(iii) Contributions to regional revitalization

With regard to "contributions to regional revitalization, etc.," the report recommends "the development of new guarantee products (including the nationwide roll-out of products currently only available to agricultural business implemented in National Strategic Special Zones) in coordination with local governments, etc., that are addressing regional issues, and support for the promotion of business creation efforts." In addition, it recommends "capital subscription of regional revitalization funds (and consideration of expansion of the subscription scope to funds other than revitalization funds)."

I would like to share my own views on the potential for capital subscription of various funds. First, the capital subscription of revitalization funds became possible with the legal revisions of 2008, and credit guarantee associations have already developed an extensive track record of this investment. However, the actual amount of capital subscription is extremely small, and at present this investment is more important symbolically than financially. Nevertheless, these efforts have been worthwhile, because it has become possible for guarantee association personnel to become involved in revitalization fund operations as revitalization fund financers and build up experiences, and this contributes to the creation of personal networks about revitalization business. This experience will contribute to the expansion of functions of credit guarantee associations. There is great potential for relaxation of prohibitions to lead to similar extension into new fields other than revitalization.

There have also been criticisms that credit guarantee associations, which have in the past only guaranteed loans, are unable to serve their functions as fund investors, and they should leave equity investment to other investors. Credit guarantee associations are, recognizing these concerns, actually becoming involved through the capital subscription of private funds. Therefore, I do not believe that the current state of capital investment, or minor expansion of this investment, will present any major problems.

I do, on the other hand, believe that credit guarantee associations need to think seriously about how they will position capital subscription in their business model from a medium- and long-term perspective. In other words, the question credit guarantee associations must consider is whether they will position fund operations as financially important operations. From the perspective of achieving the ultimate goal of improving SME productivity, there are times when providing capital funds is more appropriate than providing liability funds (i.e., loans backed by guarantees). For credit guarantee associations to strengthen their support for SMEs, it makes sense to allow them to use a broad range of financing methods.

In startup support and revitalization support operations, it is difficult to have the companies receiving the support bear the support costs at the point at which the support is offered. Instead, it is natural to reclaim the costs later, when business results are on track. The current guarantee system, though, has little in the way of performance fee elements, and in actuality, financing support is seldom recouped. Currently, credit guarantee associations still have the financial base strong enough to handle this task, but, in the future, support is expected to be positioned as their main duty, and the scale of support is expected to grow commensurately. Therefore, it is impossible to allow their support business to continue to be in a deficit in the future. When considering how the medium- and long-term sustainability of credit guarantee association operation can be achieved and how performance fee elements can be included within these operations, the expansion of capital subscription will be an effective option.

(3) Promoting information disclosure and improving operation efficiency

The report also expresses hopes for the active efforts of credit guarantee associations with respect to promoting information disclosure and improving operation efficiency in various areas.

With regard to information disclosure, credit guarantee associations do publicly release management policies, key issues, and business plans on a regular basis. They also perform internal evaluations and undergo external evaluations, so we can say that they have some degree of transparency. I have worked as an external evaluation committee member for Aichi Credit Guarantee Association since 2013, and, based on my experience, I have concluded that outside evaluations function sufficiently. Of course, they do not have monthly meetings, like the outside directors of corporations, and outside evaluation committees only meet once a year, but I have asked questions of and received explanations from the association on an as-need basis, and have made outside evaluations based on large amounts of information. However, operation practices appear to vary widely among credit guarantee associations, so outside evaluations likely need to be further enriched.

At the same time, outside evaluation committees need to evaluate credit guarantee associations based not only on conventional perspectives such as amounts of approved debt guarantee, amounts of payment in subrogation, and reclaimed amounts, but also from the perspective of achieving the ultimate objectives of improving the management of guarantee recipient companies and contributing to the vitalization of local economies. As a member of an external evaluation committee, I would like to emphasize (while also cautioning myself) the need for qualitative improvements to external evaluations.

Also important is the promotion of operation efficiency improvements. The report points out that "implementing operation efficiency improvements, such as simplifying systems and administrative procedures, is important for credit guarantee associations." As readers are surely aware, the fusion of finance and technology (fintech) is advancing at a rapid pace. Unfortunately, inspection tours to some credit guarantee associations by the Financial WG have left WG members with the feeling that credit guarantee associations still have a great deal of room for labor-savings through the use of IT.

Of course, there are also legal and regulatory demands that make it difficult to immediately eliminate printed paperwork. However, using IT to improve efficiency has the potential to reduce the document creation and submission workload placed on SMEs, accelerate screening and other procedures, and thereby improve the speed of guarantee procurement. For credit guarantee associations and financial institutions, reducing administrative processing workloads would make it possible to assign people to operations in which they are more essential. This is an issue I strongly believe should be addressed.

4. Conclusions

The Financial WG recommends reductions in the use of credit guarantees for growing companies, and, in reality, approved guarantees are significantly falling within several credit guarantee associations (Figure 1). This may leave staff members uneasy regarding the futures of their associations. I would like to share my opinions on this subject.

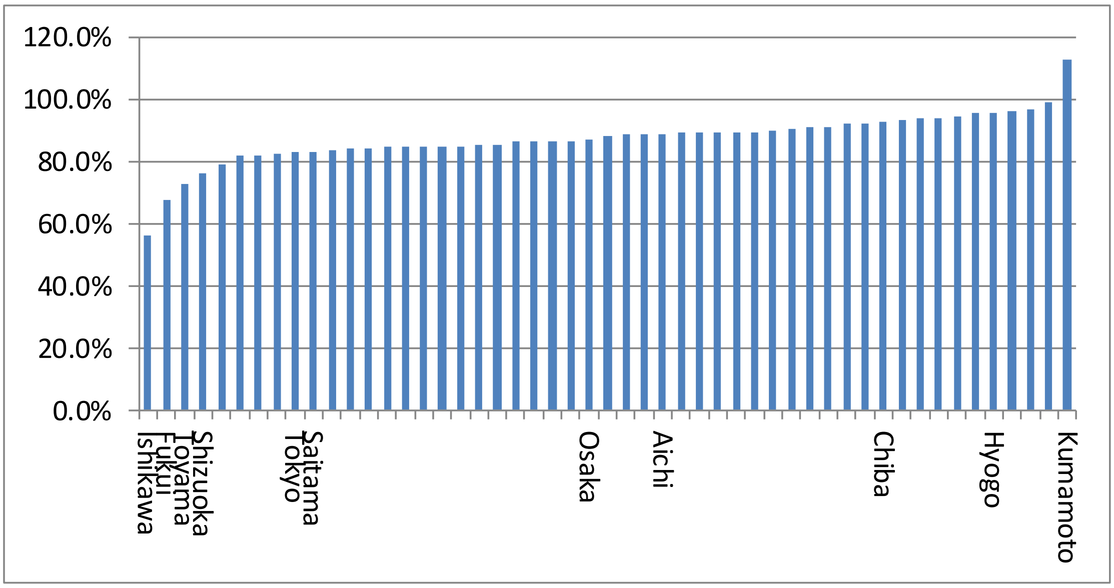
As I have stated several times above, the Financial WG does not seek to reduce the roles of credit guarantee associations. This should be clear from the fact that it recommends expanding maximum amounts of guarantee coverage for startup firms and establishing new guarantee options for revitalization.

The Financial WG has advocated that growing firms "graduate" from credit guarantees because the WG recognize that financial institutions often ask corporate customers to use credit guarantee not due to benefits of customers but due to interests of financial institutions. Namely, financial institutions can get lazy about monitoring and supporting customers if the loans are protected by the credit guarantee associations.

Stepping away from the report for a moment, my personal opinion is that I hope that credit guarantee associations increase their presence so much that companies in their growth phases want to use the guarantees provided by credit guarantee associations. For example, when purchasing an automobile insurance policy, premiums are important, but another factor which is no less important is how the insurance company handles accidents. For a company taking out a loan, a guarantee-backed loan from a credit guarantee association would provide the company with a sense of security because the credit guarantee association monitors the bank's actions. The management support and information provided by the credit guarantee association would also be valuable contributions to the company's development. I believe credit guarantee associations should strive to create these conditions, so that SMEs would spontaneously continue to use guaranteed loans instead of just conventional loans.

Through the Financial WG's deliberations, I have been left with a strong impression that local SMEs rely significantly on credit guarantee associations. Living up to those expectations is no easy matter. In a questionnaire survey sending to staff members of regional financial institutions, I found that the sense of accomplishment among staff members working for financial institutions that highly value efforts to support customers is greater than that of those working for financial institutions that do not value providing support to customers (Yamori and Yoneda, 2017). I have not conducted a study of staff members of credit guarantee associations, but I suspect that the results would be similar. If so, the new task expected of credit guarantee associations is all work which would contribute to a greater sense of accomplishment among staff members. While it may be difficult, I hope that they would find joy in this rewarding work, and take an enthusiastic approach to it.

Figure 1. Percentage Changes of Amounts of Guaranteed Loans (Comparison of the average figure of FY 2014 with that of FY 2016).



(note) This figure is based on the author’s calculation, using the disclosed figures available at the website of the Small and Medium Enterprise Agency of the Japanese Government.

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