Research Paper: Sustaining Growth of Japan's SMEs
Current Prospects and Future Financial Ecosystem

Preliminary analysis of interviews with various private, semi-private, and public support groups/financial institutions in assessing Japan's current and future financial support system for small and medium-sized enterprises

Author:

Rachel Gayle Olanoff

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Research Advisor:

Professor Toshiro Nishizawa

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THE CURRENT CLIMATE FOR SME FINANCING

The importance of supporting Japanese small and medium-sized enterprises (SMEs) in economic growth policies continues to be a politically popular issue, particularly considering the large share of SMEs in the Japanese economy in terms of number of businesses (comprising 99% of total number of business) and employment numbers (comprising nearly 70% of total employees). Nevertheless, compared to larger enterprises, SME finance generally faces the following difficulties: 1) Larger credit risks 2) Lower reliability of financial statements 3) Lack of collateral that can be provided by SMEs for traditional lending[1] 4) Larger monitoring costs and 5) Difficulty of performing business transfers due to the burdensome personal guarantee system[2]. Thus, private sector financial institutions tend to prioritize lending to large enterprises in terms of efficiencies and relatively lower credit risks, a situation worsened further by a reduction in risk appetite after several decades of economic stagnation following the bubble burst as well as other setbacks such as the global financial crisis.

In particular, SMEs may have difficulty securing long-term loans due to the increase in risk and information asymmetries between banks and SMEs, where SMEs have higher-quality information on their own management and business performance than banks. Banks in turn seek to prevent problems of *adverse selection* and *moral hazard*—lack of reliable risk measures and credit information may lead to higher risk ventures being supported than could be assessed at the time of contract formation, resulting in risky behavior after the loan on the part of businesses. Adding to institutional risk aversion towards SMEs, Japanese SMEs also suffer from low profitability and rank lower in terms of ease of credit than other Asian countries including India, Vietnam, China, Thailand, Philippines, and Indonesia. [3]

The difficulty of accessing finance and lack of proper monitoring to incentivize growth has arguably stunted the growth of the SME sector. Especially after the global financial crisis, in addition to profitability and investment in Japanese SMEs declining significantly, business registration of SMEs (in net terms) has remained stagnant. Some note that this can be due to nonviable SMEs being kept afloat with public support polices—this would lead to resource misallocation and create distortions in the competitive market. In addition, although not covered specifically in this paper, various regulatory barriers and lack of market development activities have hindered the creation of new business. [4]

PUBLIC FINANCIAL SUPPORT MEASURES AND RELATIONSHIP LENDING

Considering these challenges, two major approaches by Japanese public and private financial institutions to supply loans to SMEs are 1) the use of publicly supported SME focused lending institutions/*credit guarantees* and 2) a focus on *relationship lending*—borrowers repay loans as agreed upon in contracts in order to secure access to finance in the future; through this on-going relationship, lenders then accumulate borrowers' information including borrowers' clients, cash flow, and management capacity. In regards to public support

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[1] Traditional bank lending that is collateral or asset-based requires capital and many SMEs may not have enough security for conventional based loans. Alternatives are then information based (credit scoring, relationship lending, financial statement lending) but many companies may additionally have difficulty supplying this information. Also companies may have intangible assets (not all these assets can be offered as tangible collateral such as 'rice fields' or property)

[2] Although attempts have been made to reform the system, those interviewed repeatedly mentioned the personal guarantee system (limited liability subject to a maximum amount and duration) as a formidable financial barrier towards further SME growth/expansion since business owners must absorb all of the risk upon bankruptcy

[3] Finance to SMEs in Japan and Asia (JFSA-ADBI-IMF joint conference January 27,2014) http://www.fsa.go.jp/frtc/kenkyu/event/20140312/s2_2.pdf

[4] W. Raphael Lam and Jongshoon Lim "What Role can Financial Policies Play in Revitalizing SMEs in Japan," *IMF Working Paper*

systems to increase financial access to SMEs, Japan's system of **Credit Guarantee Corporations** (CGCs) allows for the spreading of risk burden across society with taxpayer money—private banks are encouraged to lend to SMEs if loans are backed by publicly supported CGC issued guarantees which are in turn backed in insurance by the government supported **Japan Finance Corporation** (JFC). In addition to this, the publicly affiliated financial institutions JFC and **Shoko Chukin Bank** supply long-term and low interest money to SMEs to further compliment private sector banks.[5] However public support measures also bear various costs, introducing economic inefficiencies through government market distortions. For example, such actions can create moral hazard by weakening incentive for proper credit risk assessment by lenders—this may in turn understate credit risk, limiting incentives to restructure inefficient SMEs and leading to the misallocation of resources, ultimately undermining the healthy dynamism of SMEs.

POTENTIAL RISK CAPITAL AND EQUITY/INVESTMENT BASED FINANCING FOR JAPANESE SMES

It would appear that a reliance on financing through relationship lending and credit guarantee models is insufficient to sustainably support the continued growth of SMEs in Japan. For example, some experts draw a correlation between SMEs that use credit guarantees and lengthened periods for repaying debt with a higher likelihood to incur losses. Additionally, the smaller size of **shinkin banks** and regional banks supporting local SMEs means that although these banks are close enough to individual enterprises to perform relationship lending, they lack larger scale business restructuring experience and may not have enough capital adequacy themselves to be able to absorb the shock of non-performing loans.[6]

Thus, the alternative of 'equity finance' as opposed to direct lending models, where investors make contributions to a company (sometimes by directly purchasing ownership shares) in exchange for potential return on profits (rather than interest accumulated payback), has been cited as an important incentivizing tool for SMEs to expand their businesses or *improve* business performance (either in regards to financials or social impact) to attract investors. This is in contrast to loans, where firms incur debt and the expectation is to pay back money over time, regardless of business performance. SMEs supported by risk capital or equity finance are normally classified as having higher potential returns than typical SMEs but lower risk than traditional venture capital (VC). Accordingly, recently Prime Minister Abe and his cabinet have initiated reforms to strengthen the provision of risk capital and several public/private initiatives have shifted towards fund creation to supplement VC investment in Japan.[7] Nevertheless, even with the greater provision of venture capital and better mechanisms to promote the success of potentially viable but high risk enterprises, the lack of timely credit information[8] *has a created a financing gap for "middle-risk" enterprises*, since VC and the CGS system supported bank-lending mechanisms service high-risk customers, while larger banks continue to support low-risk customers. Additionally, risk appetite in Japan remains low as exhibited by the slow pace of business restructuring, banks' heavy reliance on collateral, and preference for burdensome personal guarantees. Lacking early stage "angel" investors to supply initial capital, even venture-oriented SMEs may still be dependent on bank lending credit, and continued survival of non-viable, high-leverage low-

[5] Finance to SMEs in Japan and Asia (JFSA-ADBI-IMF joint conference January 27,2014)

[6] W. Raphael Lam and Jongshoon Lim "What Role can Financial Policies Play in Revitalizing SMEs in Japan," *IMF Working Paper*

[7] Yet, as will be further explained, not all SME missions are the target of VC/public partnerships (and not all have plans to become an IPO), and thus alternative mechanisms such as Hometown Investment Trust Funds through socially-minded investment financial intermediaries like Music Securities will become crucial for broader SME investment support.

[8] Currently financial institutions do not share credit information through a single common credit registry

profitability "zombie" SMEs weakens the credit risk assessment of banks, reducing credit availability to start-ups and higher profit model firms. [9]

Overall, venture capital and the use of risk capital remains limited in Japan. According to 2012 OECD data, despite being the third largest economy in the world, Japan ranked 17th in OECD countries for amount of venture capital investment as a percentage of GDP.[10] As many experts note, besides revision of specific policies to attract and promote the use of risk capital, greater work needs to be done to deepen capital markets as a whole.

METHODOLOGY AND SCOPE OF ANALYSIS

The following report collates takeaways from interviews with respective public/private agencies and firms regarding the future of SME finance. The scope of analysis for discussion about SME finance was limited to business activities in Japan rather than overseas business growth/activities of Japanese SMEs. For the purposes of this paper, analysis of risk capital in Japan will be divided into two types: "crowdfunding/micro-funding" (project-based funds from individual investors directed through a non-traditional financial intermediary towards SME target businesses) and venture capital (investment partnerships through the acquisition of shares and capital gain at the time of stock sale). However, venture capitalists were not interviewed directly and this sector is only explored in this paper through public initiatives to garner VC in targeted industries/regional revitalization strategies.

RESEARCH QUESTIONS

What type of businesses depend on CGS supported and non-CGS supported bank loans and why? What type of businesses depend on risk capital and why? Is it feasible to focus on risk capital as a stable means of financing for the future expansion of SMEs?

PUBLIC SUPPORT TO SMES–MORAL HAZARD VS. SAFETY NET

ROLE OF PUBLIC INSTITUTIONS IN FINANCIAL SUPPORT TO SMES

Loans to Japan SMEs		Number of users
Government-affiliated financial institutions	Small and Medium Enterprise Unit, JFC	47,000
	Micro Business and Individual Unit, JFC	930,000
	Shoko Chukin Bank	73,000
Credit Guarantee Corporations		1,460,000

National government affiliated financial institutions directly provide about 10% of total volume of loans to SMEs, most notably being The Japan Finance Corporation (JFC) for Small Business, which was established in

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[9] W. Raphael Lam and Jongshoon Lim "What Role can Financial Policies Play in Revitalizing SMEs in Japan," *IMF Working Paper*

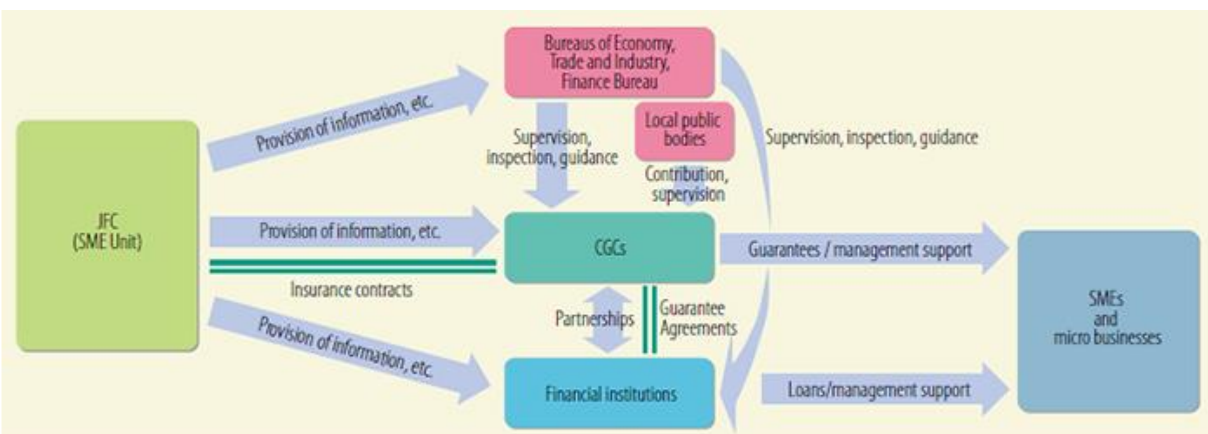
[10] OECD (2013), "Access to finance: Venture capital", in Entrepreneurship at a Glance 2013, OECD Publishing. http://dx.doi.org/10.1787/entrepreneur_aag-2013-27-en

1953 for the purpose of supplying to SMEs fixed, long-term, and low-interest funds. Added to this, the credit guarantee backed supplementation system accounts for another 10% of total volume of loans to SMEs.[11]

Tasked with supporting SMEs as a source of "economic revitalization and job creation," METI's SME Agency is in charge of deciding 1) characteristics and budget of the financial safety net (included amount compensated in the credit supplementation system) and 2) providing revitalization support (such as in the form of subsidies or funds as well as longer term, low interest direct loans) to SMEs. For example, in response to natural disaster, METI's SME agency increased the amount of public guarantees under the credit supplementation system to 100%[12] of loan value for firms affected by the Great East Japan Earthquake.[13]

Current efforts by the government, now that the economy is improving, are to monitor and limit overuse of the credit supplementation system and other publicly supported measures, in interests of fiscal austerity as well as in reducing the incidence of moral hazard for banks through risk sharing[14]. Although some worry about the expansion of public guarantees to support SMEs, after speaking with an officer of METI's SME agency, overall the financial situation appears to be stabilizing, with a decreasing trend in the total percentage of SME loan amounts backed by credit guarantees. In addition, entering credit guarantee systems is still a voluntary decision for firms which may have difficulty accessing finance otherwise, since the fee rate they must pay would be greater than the rate they would pay if they could access private bank loans directly.

Nevertheless, being attached to national interests, the agency is tasked with supporting broader SME sector financial health and doesn't have the channels to support very small or niche area SMEs which have not previously established themselves in communities. Additionally, although initiatives may be made in the future to further shift risk sharing towards private institutions, according to the official consulted, there are no plans to eliminate the credit supplementation system in the near future, particularly in ensuring that regional economies stay afloat despite lower returns for some SME businesses.



[15]

As detailed above, Japan's credit supplementation system (with loans from private banks backed by CGC credit guarantees in 51 regions nationwide, which in the case of subrogation[16], are in turn insured 70% or

[11] Roughly 90% of total private loan *amounts* to SMEs are non-guarantee backed although in terms of *number of companies*, nearly 30% of SMEs use some form of guarantee backed loan

[12] Application formally for this special provision ended March 31, 2014

[13] "Financial Policy for SMEs in Japan," Masayuki Sakata SME Agency METI June 12, 2014

[14] This approach to be detailed in the next section, but basically instead of guaranteeing 100%, guaranteeing 80% of loans instead

[15] From JFC website- https://www.jfc.go.jp/n/english/sme/demonstrating.html

[16] Subrogation here referring to the compensation by CGCs to banks when guaranteed loans are defaulted

80% by JFC) is an important component of Japan's SME finance policy. The economic rationale is that with "minimal public cost," smooth financing by private institutions can be provided to "SMEs that are in fact healthy but unable to secure enough loans because of the informational gap between lenders and borrowers." However, according to some studies, this does not wholly resolve asymmetric information gaps since most of these loans with guarantees may be issued by banks that transact with risky small businesses (adverse selection) and with such guaranteed loan contracts, risky small businesses may be more likely to default (moral hazard). Additionally, the JFC accepts all credit insurance for CGCs, implying that CGCs may have less incentive to monitor banks and small businesses.[17]

However, upon interviewing officials from JFG, the central organization of CGCs in Japan, it became apparent that efforts are being made to limit moral hazard/adverse selection through a responsibility-sharing system where only 80% of credit is guaranteed, the remainder of loan risk borne by banks.[18] In addition to ceilings on guarantees for firms with or without collateral[19], other controls and incentives include reduced fees for firms with stronger credit ratings[20], especially those which enter under the responsibility-sharing system. While JFG officials noted that there were not specific repercussions for firms or banks engaging in risky loan behavior (such as cut contracts or penalty fees), they did note that credit evaluation and bank monitoring may "become stricter." More significantly, JFG officials explained that when considering issues of information asymmetry and potential for moral hazard, it is also important to understand the financial culture of Japan and to notice the total percentage of loan amounts compensated by credit guarantees—in Japan, due to issues of saving face and close community ties (part of relationship lending), actual default risk remains low (amount of loans subrogated by CGCs nationally remains about 2%, climbing only to 3% after the financial crisis). In addition, while the total amount of outstanding guaranteed liabilities was highest in 2009, the current outstanding liabilities amounts have largely returned to pre-crisis levels (see appendix Fig. 1). Thus, the use of CGC guarantee backed loans have not been as widely abused as one may assume, and the actual amounts compensated by CGCs are much less than may be expected.

Nevertheless, the JFG officials warned that uncertainties remain about the future sustainability of the credit supplementation system, in addition to limitations in government funds to keep this system afloat. Although JFG officials noted that efforts are being made to expand the nature and form of their services to accommodate the expansion of bank offerings at the local level, they were quick to admit that they cannot support every type of financial business, and that as an intentionally limited safety net mechanism, the utility of guarantee backed loans may be outgrown as SMEs successfully expand and grow. Thus, CGCs have begun to expand their services beyond traditional financial guarantee support, such as business management training for SMEs to improve performance and credit standings.[21]

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[17] Kuniyoshi Saito, Daisuke Tsuruta "Adverse selection and moral hazard in the Japanese public credit guarantee schemes for SMEs" http://www.voxeu.org/article/adverse-selection-and-moral-hazard-japanese-credit-guarantees

[18] This system was introduced in 2007 although lost traction after the setbacks of the global financial crisis and East Japan Earthquake where emergency credit was issued to firms at 100% guarantee rate. Nevertheless, efforts are being made to reduce guaranteed amounts to 80% as the economy improves

[19] The ceiling for firms without collateral (80,000,000 yen) appears to more than enough for most firms, considering that 80% of users are microenterprises with 5-10 employees and borrowing of 10,000,000-30,000,000 yen

[20] Evaluated based on a firm's three year business performance record

[21] Nevertheless, fees are not charged for business improvement trainings run by CGCs, and it is unclear how they may continue to generate revenue without the publicly supported guarantee system

EFFORTS TO NURTURE VC-LIMITS OF HIGH-RISK/HIGH RETURN FOCUS

Recognizing the need to grow equity finance in Japan and expand the provision of risk capital to stimulate entrepreneurship and increase the return on innovation investment, Japan's Economic Revitalisation Strategy aims to raise the business start-up and closure rates from a roughly 4.5% average to the 10%[22] rate in the United States. As part of these efforts, SMRJ's SME Growth Support Fund Unit seeks to grow the market for venture capital (VC) and investment by co-funding (50%) investment of high-growth potential ventures with VC companies. As of the end of March 2014, SMRJ contributed 289.5 billion yen to a total fund amount of 651.5 billion yen to 203 venture funds, during which 139 supported companies went public. In addition to sharing risk with VCs by co-investing, SMRJ also provides business management support for venture SME enterprises, helps with business incubation and matching of VC to SME start-ups, and monitors SME growth/development with VCs. Funds are monitored for a five year period and expected to deliver a return after another five years.

In some ways this can be seen as a parallel mechanism to the credit supplementation system, supporting higher risk enterprises which, being at the start-up level, may be unable to secure traditional bank/loan relationships. In terms of the moral hazard dilemma, equity financing may be more effective since according to some studies, in comparison to banking institutions, venture capitalists have a more pronounced role in corporate governance and monitoring the companies they finance.[23] However, as officials from SMRJ admitted, the VC market in Japan remains nascent at best and before risk capital becomes more widely utilized and understood, it will be difficult to generate returns in the short term (thus, SMRJ's activities remain highly dependent on government support). Additionally the scope of start-up SMEs supported by such funds remains limited (such as high-tech firms seeking IPO). Nevertheless, SMRJ's efforts to build relationships with VC and expand the market for risk capital are notable steps towards improving SME innovation and ensuring sustainable future growth.

PRIVATE SUPPORT FOR THE "MIDDLE RISK" FINANCING GAP

While much public focus has been placed on supporting higher risk or high-growth potential enterprises, both through guarantee backed lending and/or co-investment programs with VC, still this support fails to capture the needs of a larger segment of SMEs which may exhibit slower growth but are 'middle-risk' and rely heavily on relationship lending. Accordingly, a few notable crowd-funding and multi-investor platforms from private sector have emerged to service this gap. One example of this is Kaz Ohmae's Crowd Securities Japan, an online-only securities company which provides funds to support small domestic companies (as well as micro-financing across emerging markets in Asia), listing a 5% annual yield on average. According to Mr. Ohmae, the strength in crowdfunding is that although funds are smaller, each individual lender generally contributes out of personal interest in a company and is more patient about returns[24]. Currently, Crowd Securities Japan's main offering is crowdfunding supported loan programs, popular among target SMEs. As Mr. Ohmae explained, even early stage SMEs want to show confidence in their business models, that they can pay back loans, and thus are eager to borrow. In addition to loan platforms, Mr. Ohmae hopes to expand the business by issuing crowd equity in accordance with recent changes to financial regulation. Under an FSA

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[22] Based on data measuring the period 2004-2009

[23] Financial Intermediaries, Ownership Structure, and the Provision of Capital to SMEs: Evidence from Japan http://dare.uva.nl/document/2/63531

[24] Mr. Ohmae noted that although investors may be patient, as a financial intermediary, Crowd Securities Japan cannot take excessive risk and in some aspects can be as stringent as traditional banks in checking the credit of the firms it services

2014 amendment to the Financial Instruments and Exchange Act to take effect end of May, equity fundraising will be de-regulated so that companies such as Crowd Securities Japan can begin crowdfunding equity for unlisted SME ventures, provided that such activities follow certain guidelines.

In regards to the argument that crowd funding may conflict with the venture capital space, Mr. Ohmae noted that he doesn't think the two are in competition but can rather complement each other since target SMEs may be different: as VCs may pursue more high return/high growth businesses, innovative but "more old-school" SMEs outside the scope of VC target industries can also receive a stable supply of finance through crowd-funding. As for as eliminating the current credit guarantee system, Mr. Ohmae noted that CGCs still may be necessary since credit assessment by banks remains difficult. According to Ohmae, considering the future competitive success/innovation of SMEs, a more pressing dilemma than the credit guarantee system could be the issuance of direct public subsidies to SMEs, which has kept firms afloat that are inefficiently using public resources.

However, although a promising alternative to bank lending, the scale of crowd-funding in Japan still remains small and it may be some time until more SMEs can be supported by such services as those offered by Crowd Securities Japan. As Mr. Ohmae and others noted, one public initiative to potentially increase uptake would be to include contributions towards socially minded SMEs as "tax deductibles," such as in the case of donations to non-profits in the US. In addition, to crowd-funding, another note-worthy private initiative for middle-risk SMEs is Music Securities Inc. Started in 2000, before the concept of "crowd-funding" surfaced in Japan, Mr. Komatsu created Music Securities as a Type II Financial Instruments Firm, a non-bank financial intermediary to pool micro-investments (ranging from USD 100-10,000) into business products of micro and small medium enterprises. Investors understand that unlike loans, their investment is not capital-safe, and do not buy shares or equity in target business projects; however, as part of a limited partnership agreement initiated by Music Securities with its target companies and individual investors, investors can receive a certain amount of sales returns once businesses become profitable. Regardless of investment risks, investors contribute to Music Securities administered funds due to the small amount required of individual investments (a way to share and pool risk), and the social impact of an enterprise's business mission.

The project funds administered by Music securities are significant in that they reach a niche market not supported traditionally by public or other private institutions. For example, many funds are for Japanese sake, agriculture, and fisheries, sectors not supported by CGC backed loans. The funds are also notable for their relationship lending attributes. Micro-investment allows risk to be distributed across multiple investors; nevertheless, a clear connection between lender and borrower is managed by Music Securities through tendering of the silent partnership agreement. Music Securities facilitates the creation of funds, connecting perspective enterprises to lenders after MS public accountants perform due diligence on supported businesses, looking not only at bank statements, but "from the perspective of empathy and feasibility," gauging potential investor interest and continuing to monitor businesses after an investment agreement is formed. Investors can then track the status of their supported businesses online or attend monthly seminars to meet directly with representatives from target businesses. As a result of such information sharing/relationship building, in addition to receiving returns on sales, many lenders become direct customers of the target businesses in which they invest.

Thus, Music Securities enables risk capital-based financial support of an important segment of SMEs which may not be particularly 'high return"/"high growth,' nor have the intention of becoming publicly traded (and thus outside the scope of venture capital supported funds). In addition, as such SMEs are new businesses lacking long-standing relationships in which to access traditional relationship-based lending, MS builds important connections for these SMEs, facilitating the popularization of such firms among potential investors in local areas to integrate these firms into local revitalization activities. Nevertheless, Mr. Komatsu noted that their business still has more potential to expand and widen its reach depending on changing regulatory and bank lending practices. For example, an FSA provision in 2011 which allows in some cases for "silent partnership deposits to be regarded as capital," could potentially spur bank lending to otherwise capital poor SMEs on top of investment by micro-investors. As such, Mr. Komatsu explained that they are in ongoing discussion with various financial institutions to persuade them to complement their lending activities with the micro-investment platform of music securities, with the future goal of banks one day offering MS's micro-investment options as part of their products and services at local branch offices.

In this sense, it is important to consider which types of banking counterparts may be the most appropriate partners for crowd funding or multi-investor platforms. One potential *madoguchi* or local customer 'service window' are shinkin banks, which emerged as special financial institutions for SMEs and local residents. While their lending is in principle limited to members[25], their functions are mostly the same as commercial banks as they deal with non-members as well, accepting deposits and providing exchange services in 7,500 locations across the country. Because of their extensive local reach, Shinkin banks are able to monitor their loans through relationship lending and the officials interviewed emphasized their focus on characteristics such as business "added value," and contribution to regional revitalization over pure capital gains. In this sense, Shinkin cooperatives seek to gain profits from expanding numbers of customers over focusing solely on gains per customer. The officials also explained that they are able to gather information about the businesses they work with through business support activities[26] which further improves relationship lending practices and addresses management/marketing issues "other than financing"—issues they believe will be more pressing for SMEs in the future than access to credit.

CONCLUSION

As crucial sources of employment and building blocks to Japanese economic growth, SMEs remain a central part of Japanese financial and economic policy discussion. Both public and private actors search for effective financing models in order to successfully support existing SMEs in regional economies while simultaneously encouraging market dynamism and growth through the introduction of innovative new entrant SMEs.

Although at first glance, Japan's extensive credit guarantee supplementation system may appear to be overly protectionist, propping up risk-laden low profitability "zombie firms," after speaking with various officials and looking at current data, it would appear that present use of the CGS is more demonstrative of its original intention, as a predominantly safety net mechanism, with extended use and coverage during periods of economic crisis, only to decrease in percentage of total loan amounts and subrogated ratio once the economy stabilizes. In reality SMEs seem to be employing other outlets to secure private funding as CGC backed loans only make up 10% of total private loans. This may be due in part to the efforts of METI's SME agency, JFG, and other government affiliated financial institutions to monitor use of the credit supplementation system and institute controls/incentives to check against moral hazard and abuse. Additionally, despite continuing struggles by banks to accurately access SME credit records, a point much of the literature surveyed failed to significantly address was *the pervasive nature of relationship lending in Japan's banking culture*, which became

[25] While regional banks may serve medium sized corporations and mega banks larger corporations, Shinkin Banks are targeted towards smaller businesses.

[26] Business and financial support help businesses at all levels of development but primarily support businesses that are growing and onwards rather than seed level start-ups (similar to Music Securities)

apparent especially in discussion with shinkin bank officials and multi-party funding platforms such as Music Securities which attempts to build on this culture of relationship lending. As JFG officials admitted, in the future SMEs naturally may no longer even require CGCs as a safety net to achieve stable flows of finance.

Certainly improvements can be made to public and private lending programs to introduce more competitive schemes and build more efficiency into current mechanisms (such as further reductions in the percentage of credit guaranteed by CGCs or elimination of non-performance based grants). However, after completing the interviews for this report, it became clear that publicly backed credit guaranteed loans did not necessarily crowd out the space for risk capital and innovative investment/funding platforms. In actuality, depending on the organization interviewed, the target SMEs (by risk level, sector, and/or level of establishment) differed greatly among financial intermediaries. For example, while the current credit supplementation system supports more established SMEs in specific sectors, small or niche area SMEs which are less established may not have credit supplementation available to them as a recourse of action and thus may rely on more "empathy"/social value based platforms such as Music Securities' micro-investment. Similarly, without promises of returns as high as the tech industry, such niche but high in local value SMEs (such as sake brewing projects) may be outside the current scope of SMRJ supported VC/public partnerships funds. The financing gap for such "middle-risk" enterprises may in the future be filled by the expansion of multi-investor, crowd-funding platforms such as Music Securities and Crowd Securities Japan.

Additionally, as risk appetite in Japan remains low and there is a difficulty to secure early stage "angel" investors to supply initial capital, even venture-oriented SMEs may still be dependent on bank lending credit; thus forming strong relationships with local banks willing to support start-ups should be crucial for these small enterprises to establish credit reliability. Thus, in order to facilitate SME financing, not only policy responses but also cooperation between non-traditional and traditional private financial institutions may be necessary. As Mr. Komatsu of Music Securities indicated, he hopes to one day complement their micro-investment platform with the lending activities of local banks, using the reach of their "*madoguchi*" or bank service windows to further build on the advantages of relationship lending. In this sense, traditional lending offered by institutions such as shinkin banks, rather than being in competition, may one day form the natural complement to multi-investor/multi-funder platforms.

APPENDIX

Summary of Organizations and Service Offerings

METI Small Medium and Enterprise Agency

Product Offering and/or Services	Type of Institution	Target SME customer(s)	Legal Basis	Constraints
***management support SMEs** ***decide characteristic and budget for public financial institutions**	National government	Traditional SME '*middle*' risk to *high/middle* risk and return	Small and Medium-sized Enterprise Basic Act (Act. No 154 1963)	Must support broader national/regional economy and overall health of SME sector

Japan Federation of Credit Guarantee Corporations (CGCS)

Product Offering and/or Services	Type of Institution	Target SME customer	Legal Basis	Constraints
***Credit guarantees** ***Management support**	Public financial	*'middle' high risk eligible**[27] SME	SME Credit Insurance Act 1950	*publicly insured/funded *non-profit, intended as safety net

Org. for Small & Medium Enterprise and Regional Innovation, Japan (SMRJ)-SME Growth Fund Unit

Product Offering and/or Services	Type of Institution	Target SME customer	Legal Basis	Constraints
***50% co-fund with VC to SMEs** ***promotion, monitoring, and management of VC equity investment in SMEs**	Independent administrative agency (under METI and partially MOFA)	All levels of growth but at start-up stage tech/high growth venture (*middle high risk*)[28]	Act on the Organization for Small & Medium Enterprises and Regional Innovation	Still growing VC risk capital environment so take time to see returns; fund amounts not yet widely dispersed

Crowd Securities Japan, Inc.

Product Offering and/or Services	Type of Institution	Target SME customer	Legal Basis	Constraints
***loan crowd-funding** ***equity crowd (begin at future date)**	Crowd-funding platform	Middle risk/middle return	Type I and Type II financial instrument	Currently focused on loans (debt must be repaid) to somewhat more stable businesses; social impact important but revenue oriented

Music Securities, Inc.

Product Offering and/or Services	Type of Institution	Target SME customer	Legal Basis	Constraints
"Equity" like investment (shares are not bought but investors get return on sales)	Micro-funding platform	*Medium risk/medium return* with high potential for local support/social value	Type II financial instrument; limited partnership	Not as wide reach in terms of number of businesses compared to traditional institutions

[27] *certain eligibility requirements for SMEs to apply for credit guarantee-in addition to size specifications, qualifying SMEs must be one of industries designated by SME credit insurance act, notably *excluding* agriculture, forestry, fisheries, and financial industry

[28] SMRJ activities are broad-ranging and support SMEs at all growth stages; however for analyzing risk capital activities and growing VC space, this analysis will primarily discuss the situation regarding support to start-up businesses by SMRJ's fund unit

Shinkin Central Bank (SCB)

Product Offering and/or Services	Type of Institution	Target SME customer	Legal Basis	Constraints
Loans, business start-up support, succession support/M&A, co-financing	Private financial	Small to medium size (*middle risk/middle return*)	1951 Shinkin Bank Law	Capital adequacy (although increasing) individual shinkins still small and widely dispersed

Shoko Chukin Bank Ltd.

Product Offering and/or Services	Type of Institution	Target SME customer	Legal Basis	Constraints
Loans (ex. safety net and business innovation)	Joint public and private financial institution	*Medium risk* established *member* SME	1936 Shoko Chukin Bank Law	Restricted to member organizations/firms as customers

Figure 1 (data from Japan Federation of Credit Guarantee Corporations)

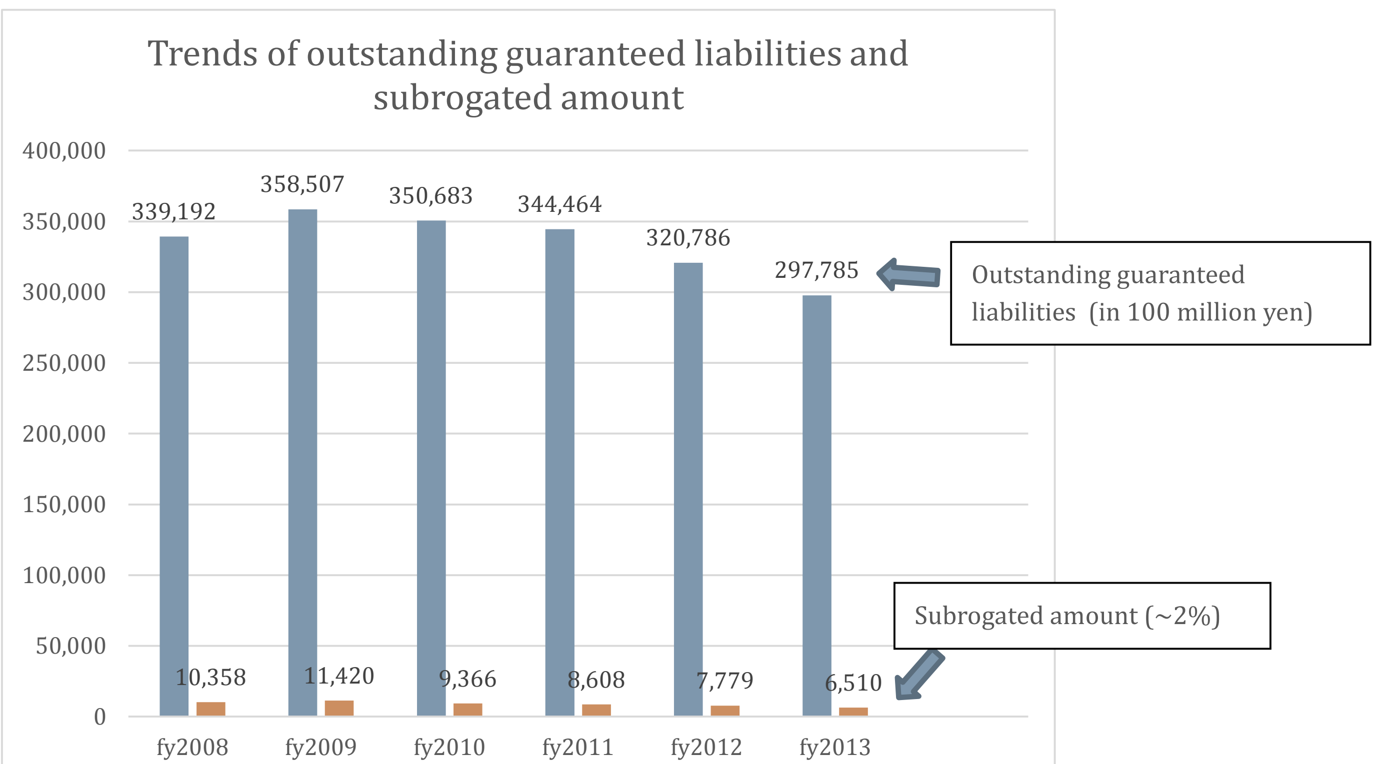

Figure 2-Sample questionnaire sent to perspective interviewees

Q1. *Abenomics* places emphasis on growing securities and venture capital for the future of SMEs. Considering the current situation, how much emphasis should be placed on traditional banks/other financial lending mechanisms and risk capital to foster smooth/sustainable growth of SMEs?

問 1　アベノミクスは、中小企業の将来のためになるとして、証券市場とベンチャーキャピタルの拡充を重視しています。中小企業の現状に照らすと、中小企業の円滑で持続可能な成長にとって、従来型の銀行融資の仕組みとリスクキャピタルのいずれがより重要でしょうか。

Q2. Among your services for SMEs, what is your primary focus and performance target? Are loans being provided as a safety net or as seed money for future growth?

問 2　中小企業向け金融サービスのなかで、とくに重視されているものは何でしょうか。また、どのような業績目標を設定されていますか。貸付は「セーフティネット」でしょうか、あるいは成長資金でしょうか。

Q3. What have been your most successful efforts to date?

問 3　これまでに最も大きな成果を上げた取り組みは何でしょうか。

Q4. What challenges do you still face in your programs?

問 4　御行（御社）が現在取り組まれている課題は何でしょうか。

Q5. Considering these challenges, how do you plan to improve your services for the future?

問 5　その課題への取り組みを通じて、御行（御社）のサービスをどのように改善することを目指しておられるのでしょうか。

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