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### **The Importance of the Shoko Chukin Bank for SMEs**

Historically, Japanese banks have played a leading role in financing Japanese corporations through their loans. However, recent financial deregulation as well as the growth of capital markets has increased the reliance of large Japanese corporations on equity financing and low-interest rate financial instruments, such as corporate bonds and commercial paper.

In the case of SMEs, loans from banks are still their major source of financing for the following reasons. First of all, access to capital market funding is still highly limited because Japanese investors are risk-averse compared to investors in the United States and are less willing to invest in high-risk, high-return products. Second, CEOs are also reluctant to rely on capital market financing in many cases. The CEOs of SMEs in Japan are often owners of the company who own the majority of company stocks and manage the company at the same time. The separation of manage-

ment and ownership will increase the conflicts of interest between them, making them vulnerable to hostile takeovers, and the fluctuations in stock price will give more influence to management decisions. Furthermore, the capital market will require SMEs to disclose more information, which is a procedure many of them are not accustomed to, as well as require more cumbersome tasks.

As a result, the size of the market itself for SMEs is much smaller than that of the United States. The total annual transactions on the Japanese OTC market are a mere one forty-ninth of those on the First Section of the Tokyo Stock Exchange as of 1999. In the United States, NASDAQ, which serves a similar purpose as the Japanese OTC market, already has more annual transactions in total value compared to that of the NYSE.

It is true that financial deregulation and increase in foreign capital are gradually changing the Japanese financial market as well as the corporate governance system in Japan toward a more Western system.

However, cultural differences between Japan and the West exist both on the investors' side and the management's side. For example, the feelings toward their companies of many CEOs of SMEs in Japan are similar to what someone might feel toward his/her family, and the last thing they would do is to sell their companies in return for money. The cultural differences in many aspects cannot be ignored in understanding the differences of the two markets.

In conclusion, we feel that the role of the Shoko Chukin Bank for SMEs in bank financing is still critical for the growth of SMEs and we will continue to play a leading role for them.

### Bank Financing for SMEs in Japan

In Japan, there are broadly two types of financial institutions that are engaged in providing funds for SMEs, private sector and governmental.

#### 1) Private-sector Financial Institutions

Private-sector financial institutions can be divided into two groups: commercial banks group; city banks, regional banks, trust banks, and long-term credit

banks, and financial institutions specializing in SMEs group; shinkin banks and credit cooperatives.

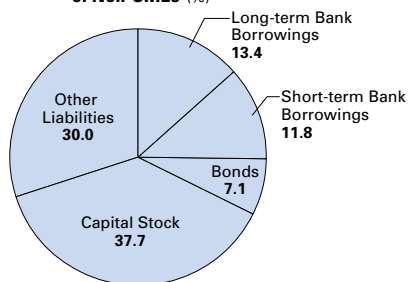
As of March 2000, the balance of overall outstanding loans to SMEs stood at about ¥317 trillion (or approximately US\$3.0 trillion), of which 70 percent was held by commercial banks and 20 percent by private specialized financial institutions for SMEs.

#### 2) Government Financial Institutions

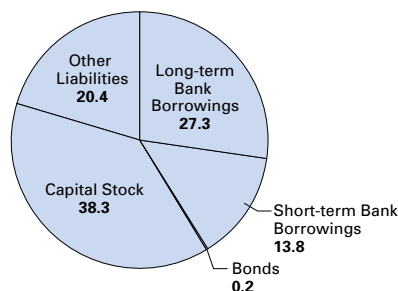
The Shoko Chukin Bank, Japan Finance Corporation for Small Business, and National Life Finance Corporation are the three government financial institutions for SMEs. Of total loans to SMEs in Japan, the loans from these three institutions account for 10 percent or about ¥31 trillion (US\$296 billion). Government financial institutions' primary mission is to support and assist SMEs. Among government-affiliated financial institutions, the Shoko Chukin Bank is the only bank that raises funds independently, primarily through debentures and deposits. Its range of business is similar to other commercial banks, including short-term financing, securities investments and foreign exchange.

#### Funding Sources of Non-SMEs & SMEs

Liabilities and Stockholders' Equity of Non-SMEs (%)



Liabilities and Stockholders' Equity of SMEs (%)



Source: Ministry of Finance (as of March 31, 2001)

### Characteristics of the Shoko Chukin Bank

Bank loans by both private-sector and government financial institutions still play a major role in financing of Japanese corporations. However, because of the higher risk of SMEs compared with

large corporations, certain limits apply to them. For example, the loans to SMEs often require collateral with strict covenants and interest rates are usually higher than the rates applied to large corporations.

This is due to higher costs required on the banks' side. The Shoko Chukin Bank plays a vital role in reducing the disadvantages of these SMEs.

The government established the Shoko Chukin Bank in November 1936 in accordance with the Shoko Chukin Bank Law. The Bank is a semi-govern-

mental institution under the joint ownership of the Japanese government and cooperatives of SMEs. As Japan's leading financial institution specializing in SMEs, the Shoko Chukin Bank provides comprehensive financial services to these enterprises through its nationwide branch network.

**Legal Definition of SMEs in Japan**

Limits (up to)	Industry			
	Manufacturing, Others	Wholesale	Retail	Service
Equity Capital	¥300 million	¥100 million	¥50 million	¥50 million
Number of Employees	300 employees	100 employees	50 employees	100 employees

Note: Meeting one of the two criteria is sufficient for inclusion in the SME category.

**The Shoko Chukin Bank Has the Following Five Fundamental Characteristics.**

**1. Government-affiliated Financial Institution**

The Shoko Chukin Bank was established with capital from the Japanese government and cooperatives of SMEs.

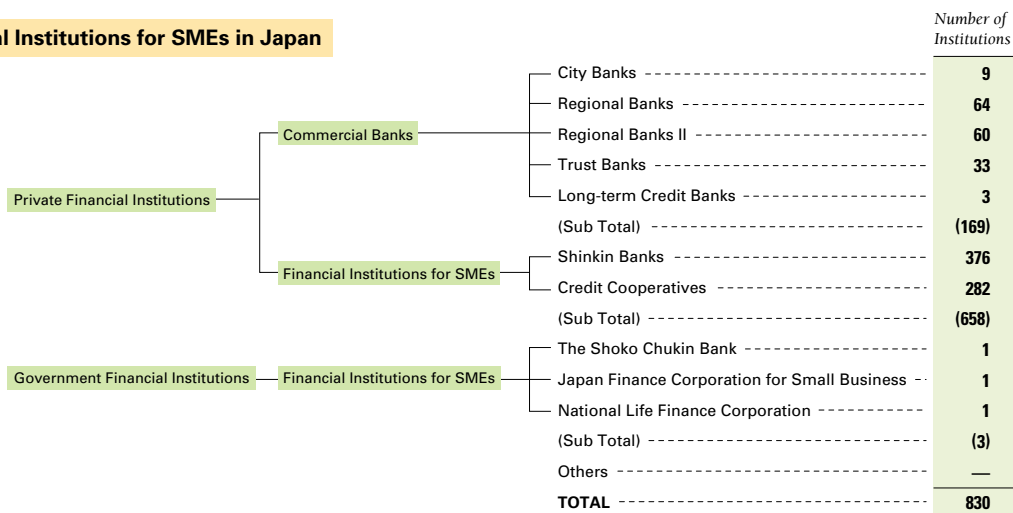
As of March 31, 2001, our capital stood at ¥493.9 billion (US\$3,986 million), of which ¥394.0 billion (US\$3,180 million) or 79.8% was owned by the government, and ¥99.8 billion (US\$806 million) or 20.2% was owned by cooperatives.

Through our loans and other consulting services to SMEs throughout Japan, the Shoko Chukin Bank utilizes the efficiency of the private sector in its authority of government affiliation.

**2. Specialization in Services to SMEs**

SMEs account for 99% of all business and employ 80% of the workforce in Japan. The flexibility and entrepreneurial spirit of this vigorous majority has built the fun-

**Financial Institutions for SMEs in Japan**



Source: Bank of Japan (as of March 31, 2001)

damentals of the Japanese economy.

The Shoko Chukin Bank specializes in financing SMEs throughout Japan and provides various services through our nationwide network. We also have very close relationships with our clients. Loan officers, representing about one-fourth of our total workforce, discuss various management issues with our clients including business operations, foreign direct investment, taxes and succession.

### 3. Financing Cooperative Activities

SMEs have disadvantages in economies of scale compared with large corporations. The Japanese government encourages SMEs to form cooperative groups to overcome this disadvantage. Through these cooperative groups, the SMEs engage in joint projects, share information, enhance their networks as well as solve various management problems.

The Shoko Chukin Bank supports SMEs in providing the know-how of organizing and utilizing these cooperative groups as well as financial support for them and their members.

### 4. A Cooperative Organization

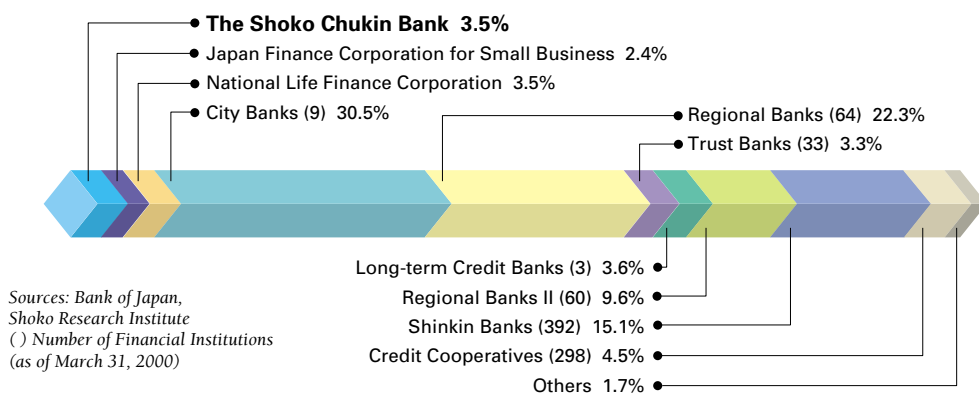
The Shoko Chukin Bank is a membership financial institution owned by cooperatives mainly organized by SMEs as well as the government. Established with the aim of facilitating their own financial institution in accordance with the principle of mutual assistance, it is “the bank of SMEs, by SMEs, for SMEs.”

Of approximately 50,000 cooperatives uniting SMEs in Japan today, more than 27,000 own the Bank’s capital. More than 130 representatives elected from these cooperatives are seated in the Assembly of Representatives, the Bank’s highest decision-making body, in which they participate in important management decision-making processes of the Bank.

### 5. A Debenture-issuing Institution

The primary source of our funds is our debentures (*Warisho*, *Rissho*, and *Rissho Wide*). The funds raised are used to provide stable loans to SMEs. Both individuals and corporations purchase our debentures as a secure way of saving and investing.

Loans Outstanding to SMEs in Japan (%)



### Close Partnership between the Shoko Chukin Bank and the Japanese Government

The Bank’s financial results have remained rather modest in comparison with large city banks. However, the Bank has close partnership with the government and this reflects in our high credit rating.

The following explains some guidelines upon which the partnership between the Shoko Chukin Bank and the government is built.

1. The Bank was established, and is governed, by a

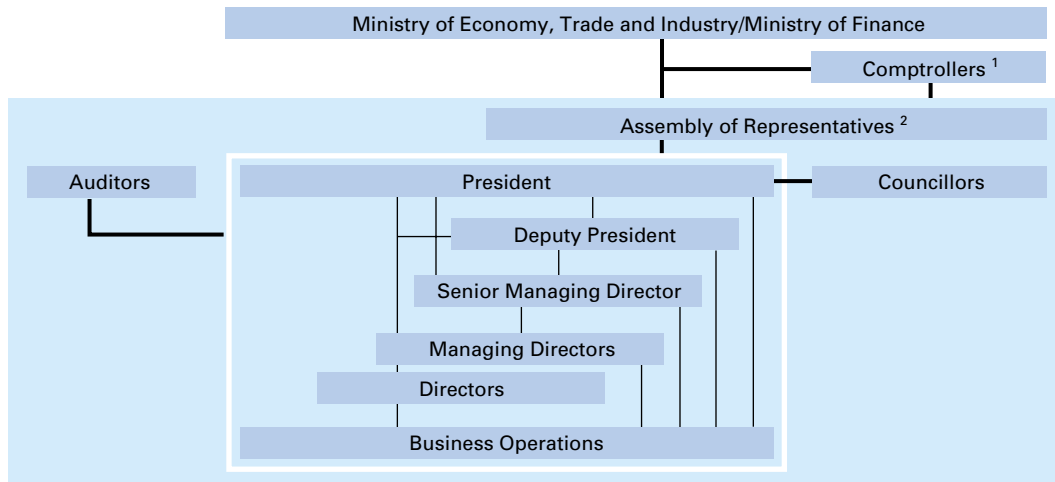
special law called the “Shoko Chukin Bank Law.” The President and Auditors of the Bank are appointed by the government. The Deputy President and Managing Directors of the Bank are appointed by the President of the Bank, subject to the approval of the government.

2. The Bank is inspected by the Ministry of Finance and the Board of Audit. It is also subject to scrutiny by the Bank of Japan. Furthermore, the two comptrollers of the Bank, who are directors of the Ministry of International Trade and Industry and the Ministry of Finance, have the authority to supervise the Bank.
3. Any resolutions of members of the Bank will not become effective without the Ministers’ approval purporting to:

- (i) alter the Articles of Incorporation of the Bank; or
- (ii) increase the capital funds of the Bank; or
- (iii) dispose of the surplus funds of the Bank

Because of the Bank’s special status as a government-affiliated financial institution, the Shoko Chukin Bank is not subject to the capital adequacy guidelines. For this reason, the Bank is approved to carry out international business despite the fact that the Bank’s capital adequacy is only 6.94%, as of March 31, 2001. It is also exempt from the government’s “Prompt Corrective Action.” Notwithstanding these exemptions however, the Bank has always endeavored to meet the BIS guidelines over the long term and to maintain the sound operation required by the “Prompt Corrective Action” directive.

**Organizational Structure**



1. The comptrollers are officials of the Ministry of Economy, Trade & Industry and the Ministry of Finance and are empowered to examine Bank records at any time.

2. The Assembly of Representatives is the decision-making body for the Shoko Chukin Bank. The representatives are selected by the Bank’s member cooperatives from among the membership.

**Growing Importance in a Changing Financial Environment**

Currently, Japanese financial institutions are going through drastic changes in the midst of a long recession, and the credit crunch to SMEs appears as though it will not recover in the near future.

The Shoko Chukin Bank is expected to provide credit to financially weak SMEs under this severe operating environment. The expectations toward the Shoko Chukin Bank have never been higher.