I. Changes in the Operating Environment

Turmoil in the Consumer Finance Market

Japan's consumer finance market is undergoing a major shakeout. Both the scale of the market and the number of finance companies are shrinking.

According to *Japanese Consumer Credit Statistics* published by the Japan Consumer Credit Industry Association, the balance of credit outstanding among consumer finance companies in Japan's consumer loan market stood at approximately ¥10 trillion from 2002 to 2005. This figure shrank sharply from 2006, however, decreasing more than 20% from its peak to ¥8 trillion at the end of 2007. Similarly, the amount of credit provided decreased 22% from its peak of ¥10.6 trillion in 2001 to ¥8.2 trillion at the end of 2007.

At the same time, the number of market participants has decreased sharply. According to statistics published by the Financial Services Agency, the number of registered money lenders decreased steadily from 14,236 companies at the end of March 2006 to 5,478 companies at the end of June 2009. As interest refund issues and amendments to the Money Lending Business Law have made the operating environment more challenging, the number of market participants has successively decreased by approximately 60% over the past three years. For example, large foreign corporations have sold their money lending businesses in Japan, small and medium-size companies have withdrawn from the market or entered bankruptcy, and credit card firms affiliated with railroad and automobile companies have withdrawn from the cashing loan business.

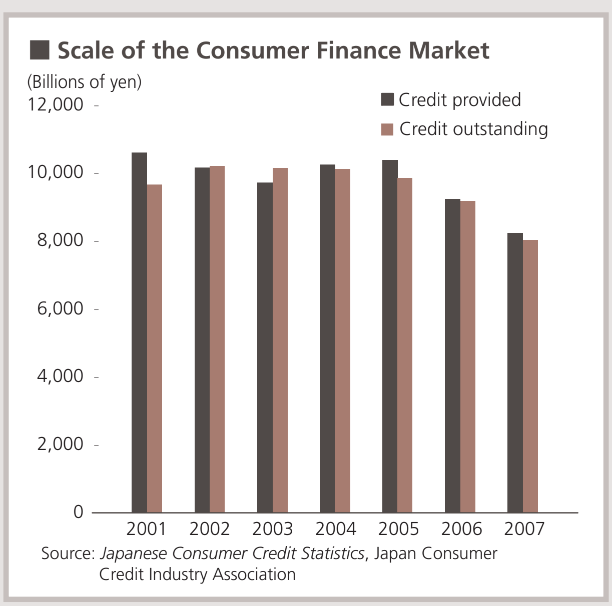
Japan's consumer finance market has therefore undergone a major shakeout since the Supreme Court's January 2006 ruling on interest refund claims and the amendment of the Money Lending Business Law in December 2006. Market shrinkage due to regulatory amendments that reduced maximum interest rates and put limits on total lending, interest refund claims that have put pressure on the financial resources of consumer finance companies, the recession, and the increasingly difficult fund procurement environment are all among the factors that have created unprecedented challenges for the consumer finance industry.

The Impact of Interest Refund Claims

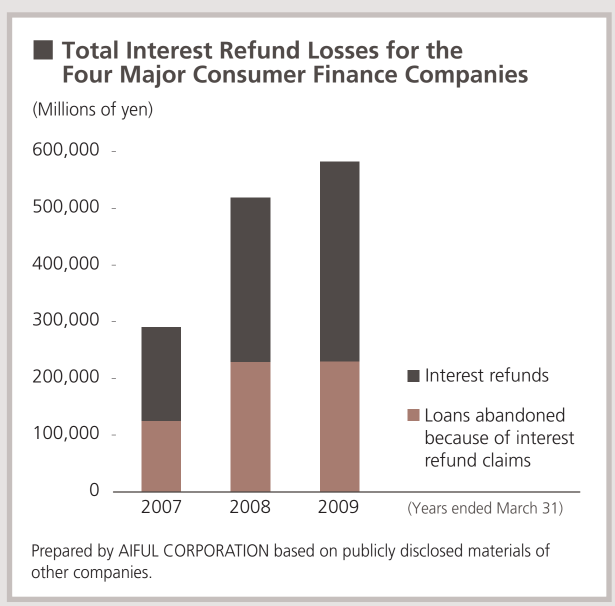
Interest refund issues have created a major operating risk for consumer finance companies.

Interest refund claims for loans carrying rates within the so-called "voluntary interest rate zone" have increased rapidly since the January 2006 Supreme Court ruling (see page 11 for details), and this has put intense pressure on the financial resources of consumer finance companies. During the three years ended March 2009, Japan's four largest consumer finance companies have already made payments exceeding ¥800 billion for interest refund claims. For loans abandoned because of interest refund claims, consumer finance companies first apply interest refunds to repayment of loan principal and then charge-off the loan. Adding the cost of these charge-offs, losses related to interest refunds have totaled approximately ¥1.4 trillion.

The large consumer finance companies handled the risk of massive losses related to interest refunds by making one-time provisions to allowances for losses on interest refunds



Source: *Japanese Consumer Credit Statistics*, Japan Consumer Credit Industry Association



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based on guidelines that the Japanese Institute of Certified Public Accountants (JICPA) issued in October 2006. Consequently, for the year ended March 31, 2007, each company recorded large net losses for the first time since going public. Subsequently, each company has continued to make additional provisions to its allowance for losses on interest refunds because interest refund claims have continued to rise, and the total of these reserves for the four major consumer finance companies was approximately ¥1.2 trillion as of March 31, 2009.

Losses related to interest refunds and provision to associated allowances have significantly impacted the financial base of consumer finance companies. Total equity for the four major consumer finance companies has decreased ¥2.1 trillion during the three years ended March 31, 2009, or 62% compared with total equity as of March 31, 2006. Viewed in terms of the depletion of financial resources, interest refund issues have become the greatest risk that consumer finance companies must deal with.

Given the risk of interest refunds, banks and other financial institutions have tightened lending to consumer finance companies. A succession of small and medium-size companies with comparatively weaker financial bases and fund procurement capabilities have either gone bankrupt or withdrawn from the industry. In addition, the companies that remain in the industry have scaled back operations and tightened credit standards in response to the burden associated with interest refunds. Consequently, consumers have fewer opportunities to make sound use of the services of consumer finance companies, whether now or in the future.

The Amended Money Lending Business Law

The amendments with the greatest impact have been the reduction of maximum interest rates and the limits on total lending.

The Law to Partially Amend the Money Lending Business Control and Regulation Law (now called the Money Lending Business Law) was passed in December 2006 with the primary goal of solving the problem of borrowers with multiple debts, and promulgated on December 20, 2006. This amendment was designed to bring more balance to the money lending business, restrain excessive lending and reduce interest rates. The amendment significantly strengthened regulation in ways such as establishing an authorized credit bureau system, strengthening the industry's voluntary regulatory functions, reducing maximum interest rates and placing limits on total lending. Given the major impact the widely ranging content of the amendment would have on the market, the authorities decided to enforce the Money Lending Business Law in four stages. The table below (Enforcement Schedule for the Money Lending Business Law) presents the content of each stage of enforcement of the amendment.

The biggest impact that the amended law will have will come from stage 4 of enforcement, which regulates pricing through reduction of maximum interest rates and regulates volume through limits on total lending.

A succession of legal amendments have reduced the maximum interest rate allowed under the Capital Subscription Law in stages from an initial annual rate of 109.5% to the current 29.2%. Stage 4 of enforcement will abolish the current deemed repayment system and reduce the maximum

■ Enforcement Schedule for the Money Lending Business Law

Stage 1 of Enforcement: January 20, 2007	Stage 2 of Enforcement: December 19, 2007	Stage 3 of Enforcement: June 18, 2009	Stage 4 of Enforcement: June 2010
■ Strengthening of criminal penalties for unregistered lending	■ Name of the law changed to the Money Lending Business Law ■ Japan Financial Services Association established as a sanctioned corporation →JFSA self-regulatory rules set ■ Business improvement order received	■ Creation of a qualification system for money lending managers ■ Authorized credit bureau system	■ Reduction of maximum interest rate (Capital Subscription Law) ■ Introduction of restrictions on total lending ■ Responsibility for reviewing repayment ability ■ Abolition of the deemed repayment system

interest rate to 20%. For reference, the maximum interest rate under the Interest Rate Restriction Law now ranges from 20% to 15% depending on principal, and loans with interest rates at variance with the maximum interest rate under the Capital Subscription Law of 20% will be subject to administrative penalties.

At the same time, a limit on total lending restricting the total of all loans to one-third of the borrower's annual income will be introduced as a measure to restrain excessive borrowing. The limit on total lending will entail strengthening the review of the ability of borrowers to repay loans, such as verifying income prior to making loans exceeding ¥500 thousand. Moreover, consumer finance companies will become responsible for using the authorized credit bureau established pursuant to stage 3 of enforcement in June 2009 to regularly check on customer balances, including borrowings from other companies, and controlling the amount of credit extended. Based on past experience with reduction in maximum interest rates, the consumer finance industry will be able to respond relatively smoothly to issues such as updating contracts. However, the limit on total lending is unprecedented and is forecast to temporarily disrupt the market when it is enforced.

The Market Impact of the Amended Law

Decreases in the approval rate for new loans and in loans outstanding are likely to reduce the profitability of consumer finance companies.

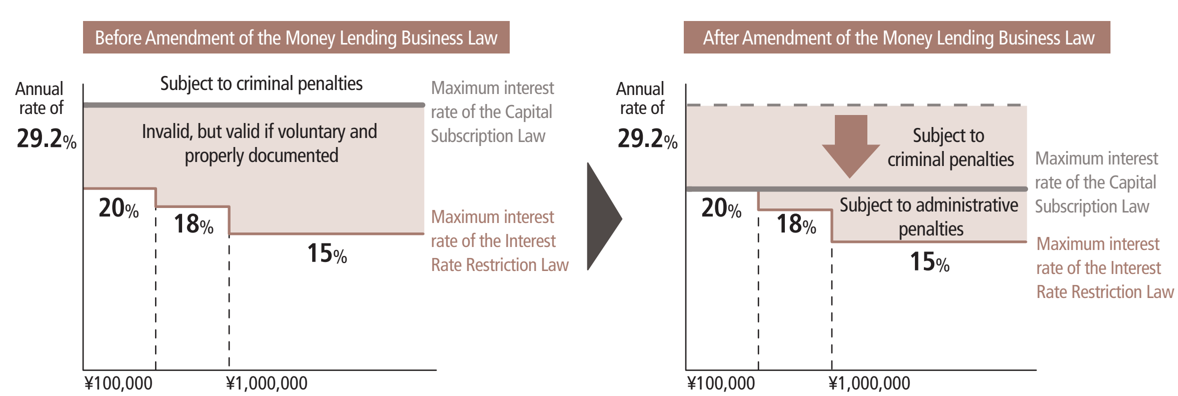
Based on the principle of free competition in a market economy, large consumer finance companies have employed their cumulative lending know-how and innovative marketing techniques to voluntarily reduce interest rates on loans in advance of the reduction of maximum interest rates under the Capital Subscription Law. For example, a legal amendment enforced in June 2000 reduced the maximum interest rate to 29.2% from 40.004%, but large consumer finance companies had already reduced their average interest rate on loans to approximately 25.5%.

However, the current amendment will regulate pricing while placing unprecedented restrictions on volume. The overall market impact is therefore likely to be significant.

Pricing risk is fundamental to the consumer finance business. Conventionally, companies conduct appropriate credit management using a scoring system to extend credit in small amounts at high interest to customers who are a high credit risk, and larger amounts at lower interest to low-risk customers. Reduction in maximum interest rates and the introduction of restrictions on total lending will therefore reduce the risk tolerance of consumer finance companies and the conventional framework will cease to function. Consequently, money lenders will no longer be able to respond to consumer demand, which will lead to a decrease in the approval rate for new loans and in loans outstanding. In fact, the four major consumer finance companies are already marketing products with interest rates below the limits of the Interest Rate Restriction Law. However, they have also tightened lending criteria, which has caused the approval rate to decrease from 63% for the year ended March 31, 2006 to 34% for the year ended March 31, 2009.

Moreover, interest income will decrease as a direct function of lower yields due to reduced interest rates and the decrease in loans due to the restriction on total lending, thus

■ Maximum Interest Rates Before and After Amendment of the Money Lending Business Law



substantially reducing the profitability of money lenders. Many small and medium-size companies operating at the current maximum interest rate of 29.2% will be forced to exit the market because their revenue model will no longer be tenable. At the same time, even large consumer finance companies will need to rapidly build new revenue models while emphasizing cost reductions through means such as closing branches and reducing personnel. The operating revenue of the four major consumer finance companies for the year ended March 31, 2009 decreased ¥431.6 billion, or 33%, compared with the year ended March 31, 2007, when the amendments were passed. The substantial decrease over the same period of ¥410.5 billion, or 35%, in interest income from unsecured loans among the four major consumer finance companies was especially pronounced. Looking forward, consumer finance companies are forecast to further tighten lending as part of their full-scale response to the restriction on total lending, which has the potential to further reduce the profitability of each company.

Thus the reduction in maximum interest rates and restrictions on total lending will substantially affect the core of the consumer finance business.

Market Outlook

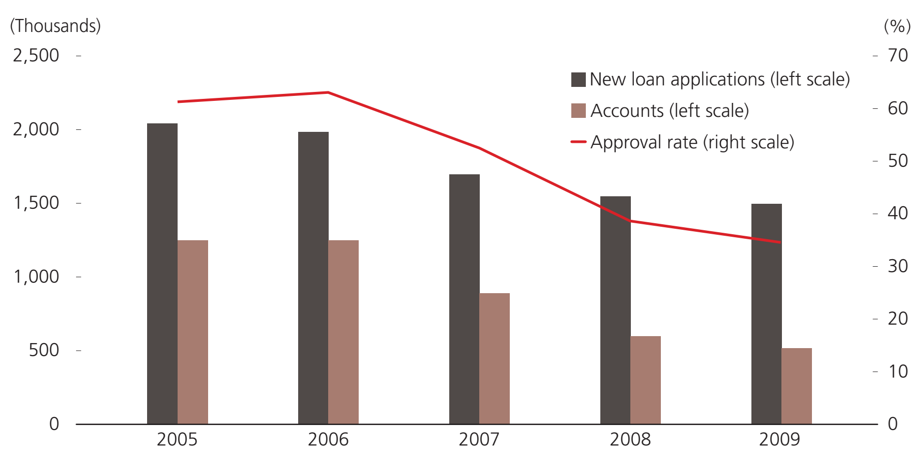
The consumer finance market is forecast to begin expanding moderately after bottoming out in the year ending March 31, 2011.

Interest refund claims have reduced the ability of consumer finance companies to lend, and stage 4 of enforcement of the Money Lending Business Law will cause them to maintain tight lending. Moreover, the impact of the recession and the challenging fund procurement environment will be other factors precluding a recovery in the results of consumer finance companies over the short term. The market is therefore forecast to continue shrinking.

However, over the medium-to-long term, the full-scale enforcement of the Money Lending Business Law will significantly reduce the credit costs and increase the risk tolerance of consumer finance companies by reducing the number of borrowers with multiple debts. The abolition of the voluntary interest rate zone and continued tight lending will allow consumer finance companies to replace the receivables in their portfolio while leading to the resolution of interest refund claims, which are increasing at present. Banks and other financial institutions will relax their tight lending stance with the decrease in potential business risk, which will ease the procurement of operating capital. As a result, consumer finance companies will be able to begin focusing on growth again.

In light of these factors, the consumer finance market is forecast to bottom out from the effects of stage 4 of enforcement in the year ending March 31, 2011 and subsequently enter a phase of moderate expansion. The AIFUL Group will overcome the current challenging operating environment by meeting customer needs. We will contribute to the creation and development of a sound consumer finance market and fulfill our social responsibilities as a consumer finance company.

■ New Applications, Accounts and Approval Rate for the Four Major Consumer Finance Companies (Total Unsecured Loans)



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