

II. Interest Refund Claims

The Voluntary Interest Rate Zone and Deemed Repayment System

Loan interest rates are mainly regulated by the Capital Subscription Law, the Interest Rate Restriction Law and the Money Lending Business Law.

The issue of interest refund claims is exerting a major impact on consumer finance companies. This section explains a key to understanding this issue, which is the legal framework that has historically regulated the interest rates on loans extended by consumer finance companies.

Today, the interest rates on loans extended by Japanese consumer finance companies are mainly regulated by the Capital Subscription Law, the Interest Rate Restriction Law and the Money Lending Business Law (formerly the Money Lending Business Control and Regulation Law). Among these laws, the maximum interest rate stipulated by Article 5, Paragraph 2 of the Capital Subscription Law has been reduced in stages from 109.5% from the enforcement of the law in 1954 until October 1983, to 73.0% from November 1983 to October 1986, to 54.75% from November 1986 to October 1991, to 40.004% from November 1991 to May 2000, and to 29.2% from June 2000 to June 2010 (projected). Consumer finance companies have set interest rates within the scope of the maximum interest rate because they would be subject to criminal penalties for charging customers more than the maximum interest rate under the Capital Subscription Law.

In addition, Article 1, Paragraph 1 of the Interest Rate Restriction Law, which was enacted in 1954, stipulates that the maximum interest rate is 20% where the principal is less than ¥100,000, 18% where the principal is ¥100,000 or more but less than ¥1 million, and 15% where the principal is ¥1 million or more, and that contracts bearing interest exceeding these stipulated levels (excessive interest) are invalid. However, Article 1, Paragraph 2 of this law states that debtors who have voluntarily paid excess amounts are not entitled to claim refunds. Moreover, the Interest Rate Restriction Law does not stipulate civil penalties for charging interest that is greater than the maximum rate set by the law. Consumer finance companies, including AIFUL therefore considered contracts for cash loans to consumers as voluntary from their inception and made loans in the so-called voluntary interest rate zone with interest rates above the maximum rate stipulated by the Interest Rate Restriction Law but below the maximum rate stipulated by the Capital Subscription Law.

In sum, although routine operations were not problematic until the enactment of the Money Lending Business Control and Regulation Law in 1983, more than one interpretation of the validity of excess interest was possible when litigation occurred. To a certain extent, the legal framework of the money lending business was therefore unstable.

Subsequently, in the first half of the 1980s the problem of multiple debts became serious, and institutions such as the mass media used the oppressive actions of certain money lenders and other events to transform it into a social issue. As a result, legal amendments gained momentum among the public and the Diet. In 1983, money lenders became required to register with the national or relevant prefectural government. The Money Lending Business Control and Regulation Law was also enacted as a legal framework for the money lending business rather than regulating it within the legal framework for financial institutions. At the same time, amendments to the Capital Subscription Law reduced the maximum interest rate in stages to 40.004%, and Article 43, Paragraph 1 of the Money Lending Business Control and Regulation Law clearly defined the conditions that legally validated the so-called deemed repayment, or the voluntary payment of excess interest. The defined conditions were as follows.

1. The money lender was registered.
2. Documents as stipulated in Article 17 of the Money Lending Business Control and Regulation Law were issued to customers when the loan was provided (documents clearly specifying the conditions of the contract and the loan, including the interest rate on the loan).
3. The documents stipulated in Article 18 of the Money Lending Business Control and Regulation Law were issued upon receipt of repayments from the customer (documents clearly specifying issues such as amount received and the amounts applied to principal and interest).
4. The customer made the payment voluntarily.

If these four conditions were met, even if a borrower made a claim for an excess interest refund, in principle the lender was considered not to be obligated to make an excess interest refund.

Many consumer finance companies, including AIFUL, developed the money lending business as registered money lenders under the Money Lending Business Control and Regulation Law. Based on assumptions about the interest rate system resulting from the enactment of Article 43 of the Money Lending Business Control and Regulation Law, these consumer finance companies created contracts and other customer documentation as well as the specifications for equipment such as automatic contract machines and automated teller machines (ATMs) under the supervision and guidance of the regulatory authorities, first the Ministry of Finance and then the Financial Services Agency. As a result, until the Supreme Court ruling of January 2006 negated deemed repayment as non-voluntary in cases where customers were saddled with multiple debts, although companies refunded interest following litigation or a settlement, it was the exception, and did not exert a significant impact on results.

With a clear legal framework and a steady business base, large consumer finance companies generated stable profits and went public in succession during the 1990s. The equity alliances concluded by two large consumer finance compa-

nies with respective megabanks in 2004 exemplified the steady performance of the industry.

The Supreme Court Ruling of January 2006

A Supreme Court ruling triggered a rapid increase in interest refund claims and led to the amendment of the Money Lending Business Law.

On January 13, 2006, AIFUL Group business loan subsidiary City's Corporation lost a case brought before the Supreme Court. The ruling in this case resulted in the substantial impact of the issue of interest refunds.

Conventionally, consumer finance companies including the AIFUL Group and customers borrowing money concluded a consumer cash loan contract similar to the contract banks and other financial institutions generally use for consumer cash loans, which contained an acceleration clause requiring a customer unable to make principal and interest payments on a loan that is in arrears to repay principal, accrued interest and late fees in a lump sum.

However, the Supreme Court ruled that the routine use of acceleration clauses in effect coerced payments in the voluntary interest rate zone that the debtor was not obliged to make. Therefore, the Supreme Court further ruled that these payments could not be regarded as voluntary, and do not satisfy the conditions of deemed repayment under Article 43 of the Money Lending Business Control and Regulation Law.

Moreover, in connection with the delivery of receipts by consumer finance companies that had received payments from customers (Article 18 documentation), the Supreme Court ruled that Article 15, Paragraph 2 of the Enforcement Regulations of the Money Lending Business Control and Regulation Law, a Cabinet Office Ordinance clearly specifying that information such as the date of the agreement can be substituted for an agreement number on receipts, is invalid since it is outside the mandate of the law. The Supreme Court also ruled that the content of any documentation that consumer finance companies conventionally provided to customers based on governmental and administrative guidance could not require deemed repayment under Article 43 of the Money Lending Business Control and Regulation Law.

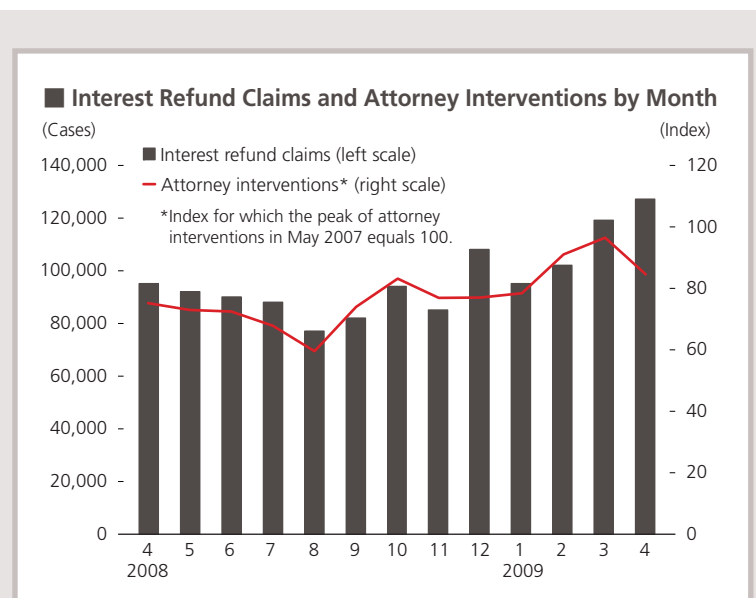
Regardless of the debate about the pros and cons of these decisions and whether they were appropriate that has continued to the present, the Supreme Court's ruling has been a major catalyst driving the rapid increase in petitions by attorneys and judicial scriveners for the refund of excess interest payments that they claim were not required under the Article 43 system of deemed repayment. These petitions are known as interest refund claims or excess payment refund claims. Moreover, coverage of the ruling and consequent issues such as the administrative penalties to which the AIFUL Group was subject made money lenders seem as if they had illegally obtained interest payments through illegal loans.

Consequently, public opinion was critical of consumer finance companies, with the result that the Money Lending Business Law was amended in December 2006 in the same spirit as the Supreme Court ruling.

Impact on the AIFUL Group

The AIFUL Group continues to experience losses related to interest refund claims, and the number of attorney interventions remains at a high level.

Given the effect of the Supreme Court ruling, in March 2006 JICPA announced guidelines on auditing consumer finance companies that take into account the Supreme Court ruling concerning the application of repayment rules stipulated under the Money Lending Business Control and Regulation Law. It established the accounting treatment money lenders such as consumer finance and credit card companies should use in recording an allowance for losses on interest refunds equivalent to projected future interest refunds as of the balance sheet date. Accordingly, the AIFUL Group recorded an allowance for losses on interest refunds beginning with the year ended March 31, 2006, which at that time totaled ¥21.0 billion. With the subsequent increase in interest refund claims, in October 2006 JICPA announced new accounting guidelines, "Application of Auditing for Provision of Allowance for Losses for Reclaimed Refund of Interest in the Accounting of Consumer Finance Companies," and required early adoption by the subject companies. These guidelines direct lenders to classify loans by payment status (paid off or in process) and then determine loan attributes including the number of refund claims that have resulted in actual refunds



and the average refund amount to calculate an estimate of future refunds and make a one-time provision to the allowance for them. The AIFUL Group therefore recorded an allowance in accordance with the new standard beginning with the six-month period ended September 30, 2006. Ultimately, for the year ended March 31, 2007 the AIFUL Group recorded an allowance for losses on interest refunds totaling ¥362.6 billion, and as a result recorded its first major net loss since going public.

Prior to the Supreme Court's ruling, the AIFUL Group paid interest refunds totaling ¥4.1 billion during the year ended March 31, 2005. However, one year after the ruling, the AIFUL Group's interest refunds had increased by nearly a factor of nine to ¥36.3 billion for the year ended March 31, 2007. Interest refunds then doubled to ¥73.2 billion for the year ended March 31, 2008. This did not represent a peak as interest refunds for the year ended March 31, 2009 were essentially unchanged at ¥72.8 billion. Also during the year ended March 31, 2009, loans abandoned because of interest refund claims totaled ¥68.6 billion and the AIFUL Group's losses associated with interest refunds increased 2.5% year on year to ¥141.5 billion. These were major factors depressing results for the fiscal year.

In addition, the AIFUL Group looks at the number of attorney interventions as a leading indicator of interest refunds. This indicator trended downward for the 20 months to January 2009 from its peak in May 2007, but the trend reversed from February 2009 and the indicator began rising. The number of attorney interventions appears to be dropping somewhat, but remains high. Factors that have kept interest refund claims at a high level include the recession, the bankruptcy of several consumer finance companies, and an increase in advertising in venues such as television and mass transit by attorneys and judicial scriveners who handle interest refund claims.

Based on these conditions, during the year ended March 31, 2009 the AIFUL Group provided an additional ¥100.1 billion to allowances related to interest refunds, consisting of provision of ¥58.3 billion to the allowance for losses on interest refunds and ¥41.8 billion to the allowance for loans abandoned because of interest refund claims. As of March 31, 2009, allowances related to interest refunds totaled ¥212.6 billion, consisting of an allowance for losses on interest refunds totaling ¥124.1 billion and an allowance for loans abandoned because of interest refunds totaling ¥88.4 billion.

The amount of interest refunds is proportional to excess interest received in the past, and is therefore related to factors including customer transaction periods and the volume of loans outstanding. The AIFUL Group is a relative newcomer among Japan's four large consumer finance companies, and experienced rapid growth during the second half of the 1990s. As a result, our average loan balance is about 60% to 70% of the loan balances of our large competitors and the

amount of actual refunds is comparatively lower. Given this situation, we believe we have rationally estimated the amount of interest refunds and the allowances for them based on factors such as the historical amount of refunds and recent refund trends, and we will maintain our allowances according to appropriate standards.

Outlook

Over the medium-to-long term, we will resolve interest refunds through tighter lending and improvement in the quality of receivables.

The burden of interest refunds is a significant issue for consumer finance companies including the AIFUL Group. However, the AIFUL Group is now proactively dealing with the reduction in maximum interest rates by providing new loan products with interest rates of 18% or less to high-quality new and existing customers. AIFUL CORPORATION has made steady progress in replacing the receivables in its portfolio, and as of March 31, 2009, 46% of its unsecured loans carried an interest rate of 18% or less. The number of loans that are readily subject to interest refund claims will decrease in the future because of tighter lending, leading to the resolution of interest refunds over the medium-to-long term.

Conversely, the financial resources and shareholder value of consumer finance companies including the AIFUL Group will continue to decrease if interest refunds continue unabated or increase as a moral hazard that is a business opportunity for certain attorneys and judicial scriveners driven by excessive advertising, more akin to ambulance chasing in the United States than a method of relief for multiple debtors. In this case, rather than contributing to the functioning of the national economy as per Article 1 of the Money Lending Business Law, the consumer finance industry could cease to exist in Japan.

This would run counter to the purpose of current legislation. In other words, it would take away the opportunity for customers to make use of sound consumer finance services in the future, and that could in fact harm the national economy. Going forward, the AIFUL Group will therefore deal with the issue of interest refunds by putting every possible effort into resolving the problem of multiple debts and providing relief to customers who have taken on multiple debts while also asserting claims we feel are valid through means such as negotiated settlements that reduce interest refund losses and individual lawsuits. This will allow the AIFUL Group to continue fulfilling its social purpose and mission of providing credit opportunities as it fulfills its obligation to preserve shareholder and corporate value.