



**IMF Country Report No. 17/244**

**JAPAN Financial System  
Stability Assessment:  
Comments**



Mamoru Nagano  
Seikei University

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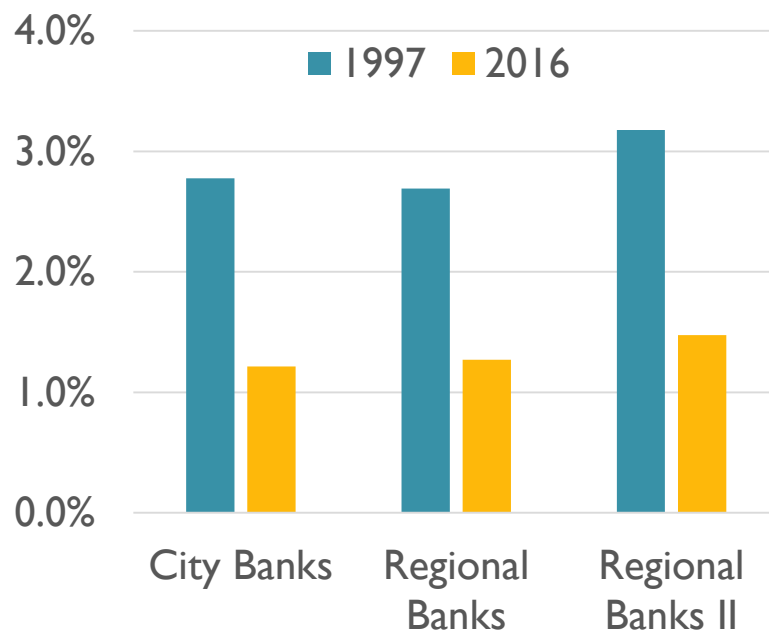
# I. Overview: 2017 FSAP on Japan

- Long-term low interest policy and declining population are two major determinants that structurally reduce banks' profitability.
- A diminishing net interest margin not only deteriorates a bank's financial performance but also encourages risk tolerance.
- Improvement in the JFSA's financial oversight is required, while the adoption of a new business model should be challenged, especially for regional banks and Shinkin banks.
- Further enhancement of bank corporate governance and capital adequacy should be increasingly promoted.
- An increase in the partner borrower productivity improves regional bank performances. Bank consolidation is not always required to improve profitability of each bank.

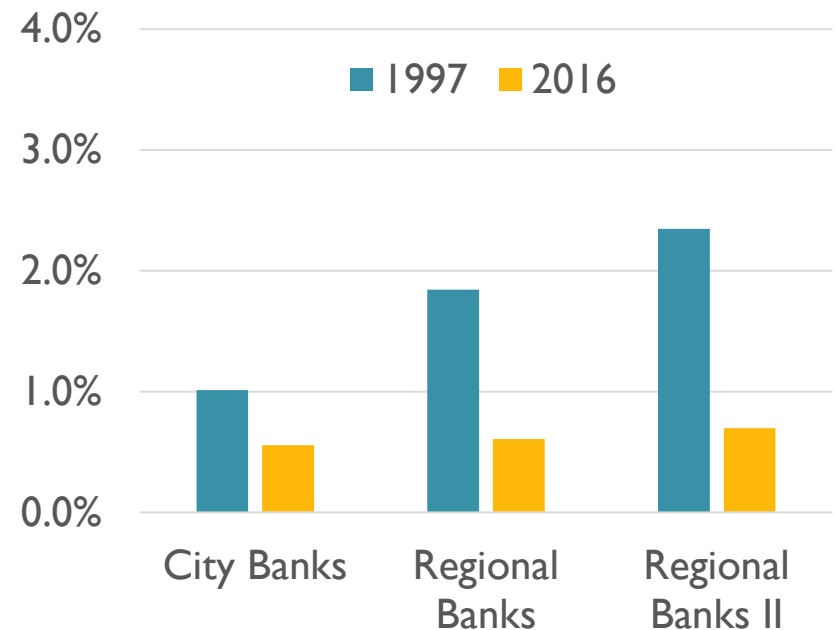
## II. Comment I: Is Long-term Low Interest Rate Policy really a New Risk for Financial Instability?

- In the past 20 years, bank lending interest rates and deposit interest rates have been lowered considerably and net interest margins have consequently diminished.
- As regional banks have a significant number of lending relationships with local SMEs, the diminishing spread is no longer enough to cover the credit risks of those borrowers.

**Figure. Average Bank Lending Interest Rates**



**Figure. Loan-Deposit Net Interest Rate Margins of Banks**



Source: Japan's Financial Institutions Directory, CD-ROM version, The Japan Financial News Co. Ltd.

**Table. Number of Partner Borrower Firms by Main Bank in Hiroshima Prefecture (December 2016)**

|           |                              | Number of Borrower Firms | Share(%) |
|-----------|------------------------------|--------------------------|----------|
| <b>1</b>  | Hiroshima Bank               | 13,987                   | 36.6     |
| <b>2</b>  | The Momiji Bank              | 6,869                    | 18.0     |
| <b>3</b>  | Hiroshima Shinkin Bank       | 4,702                    | 12.3     |
| <b>4</b>  | Chugoku Bank                 | 2,741                    | 7.2      |
| <b>5</b>  | Kure Shinkin Bank            | 1,761                    | 4.6      |
|           | ...                          |                          |          |
| <b>13</b> | Bank of Tokyo-Mitsubishi UFJ | 328                      | 0.9      |
| <b>14</b> | Mitsui-Sumitomo Bank         | 290                      | 0.8      |
| <b>15</b> | Mizuho Bank                  | 251                      | 0.8      |

Source: Teikoku Databank. Ltd.

**Table. Number of Partner Borrower Firms by Main Bank in Miyagi Prefecture (December 2016)**

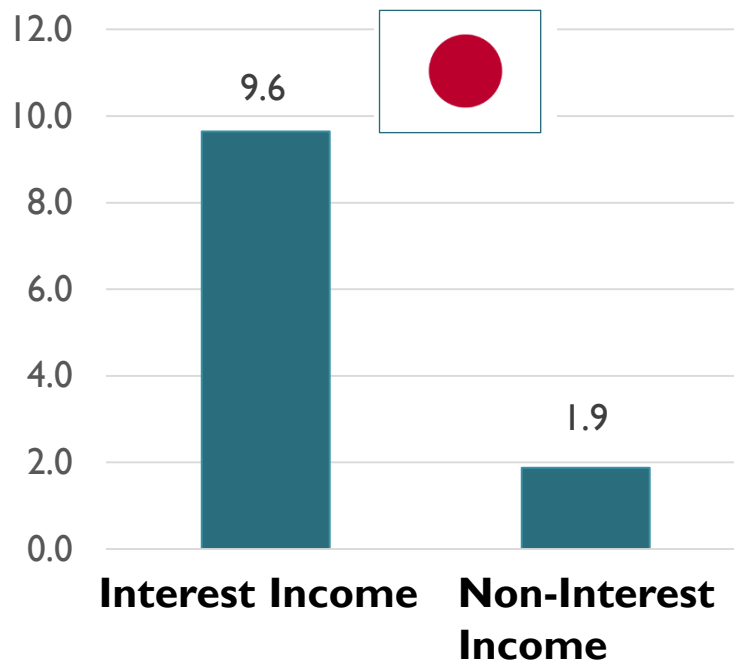
|           |                               | Number of Borrower Firms | Share(%) |
|-----------|-------------------------------|--------------------------|----------|
| <b>1</b>  | The 77 Bank                   | 13,683                   | 55.8     |
| <b>2</b>  | Sendai Bank                   | 3,095                    | 12.6     |
| <b>3</b>  | Morino-Miyako Shinkin Bank    | 1,548                    | 6.3      |
| <b>4</b>  | Sennan Shinkin Bank           | 591                      | 2.4      |
| <b>5</b>  | Ishinomaki Shoko Shinkin Bank | 493                      | 2.0      |
|           | ...                           |                          |          |
| <b>12</b> | Bank of Tokyo-Mitsubishi UFJ  | 232                      | 1.0      |
| <b>15</b> | Mitsui-Sumitomo Bank          | 205                      | 0.8      |

Source: Teikoku Databank. Ltd.

# III. Comment 2: Is a New Business Model Feasible for Regional Banks?

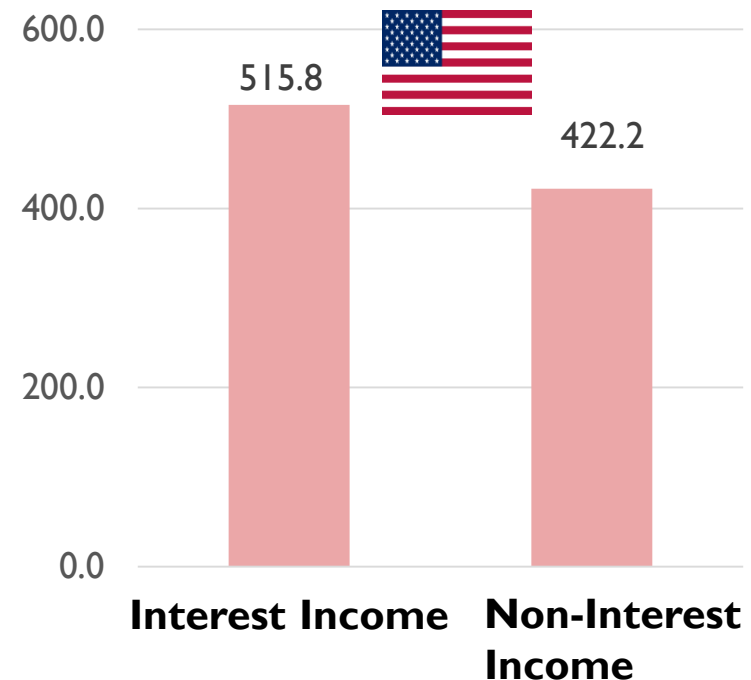
- Commercial bank interest revenues account for 79 percent of the total in 2016.
- Interest revenues from wholesale markets account for 72 percent of the total.
- Therefore, an increase in the revenue from the retail non-interest income market mitigates future possible financial instability under long-term low interest rate policy.

**Figure. Revenue Sources of Japanese Banks (March 31, 2016)**



Source: Japanese Bankers Association, Trillion JPY, Data denote the sum of 113 commercial banks in Japan

**Figure. Revenue Sources of U.S. Banks (December 31, 2016)**

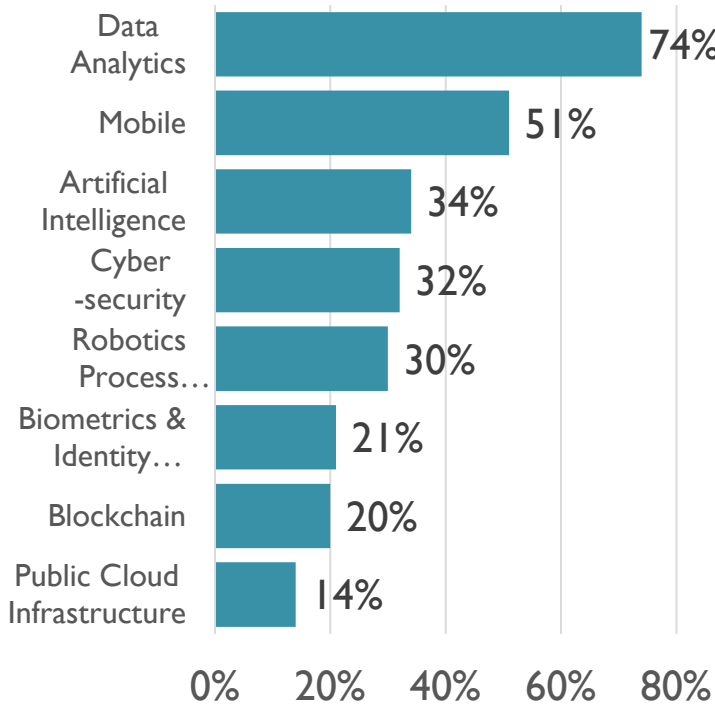


Source: U.S. Federal Deposit Insurance Corp., Billion USD, Data denote the sum of 5,137 U.S. commercial banks.

# IV. Comment 3: Is *FinTech* a Breakthrough Innovation for Banks' Profitability?

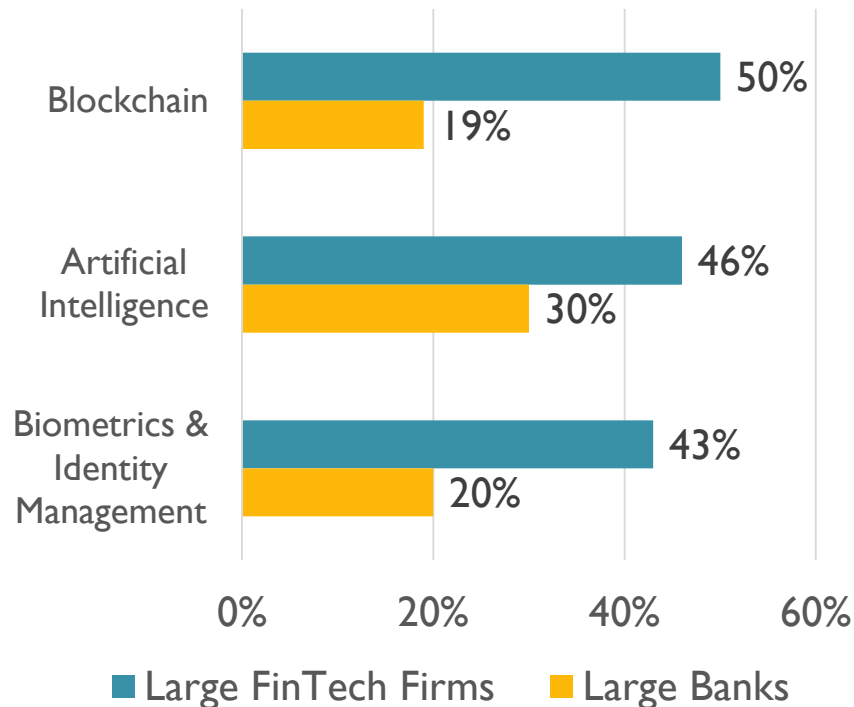
- Most financial technology contributes to an increase in retail banking market revenues.
- However, significant technological innovation requires large-scale fixed investment.
- Blockchain technology is key to increasing revenues from the retail market.

**Figure. Technological Areas of FinTech Firm Investment (PwC Survey Result in 2017)**



Source: PwC Global FinTech Survey 2017, %

**Figure. Emerging Technologies Focused by Banks and FinTech Firms (PwC Survey Result in 2017)**



Source: PwC Global FinTech Survey 2017, %

# V. Comment 4: Does A Merger Wave Hit Regional Banks in Japan?

- The existing lending relationship has built de facto inter-state regulations in Japan.
- Meanwhile, after the *Riegle-Niel Act* of 1994, the number of U.S. banks decreased from 12,000 to 7,000, as those banks have historically focused on the retail banking business.

Figure. Regional Bank Branch Geographical Distributions in East Japan (Dec. 2016)

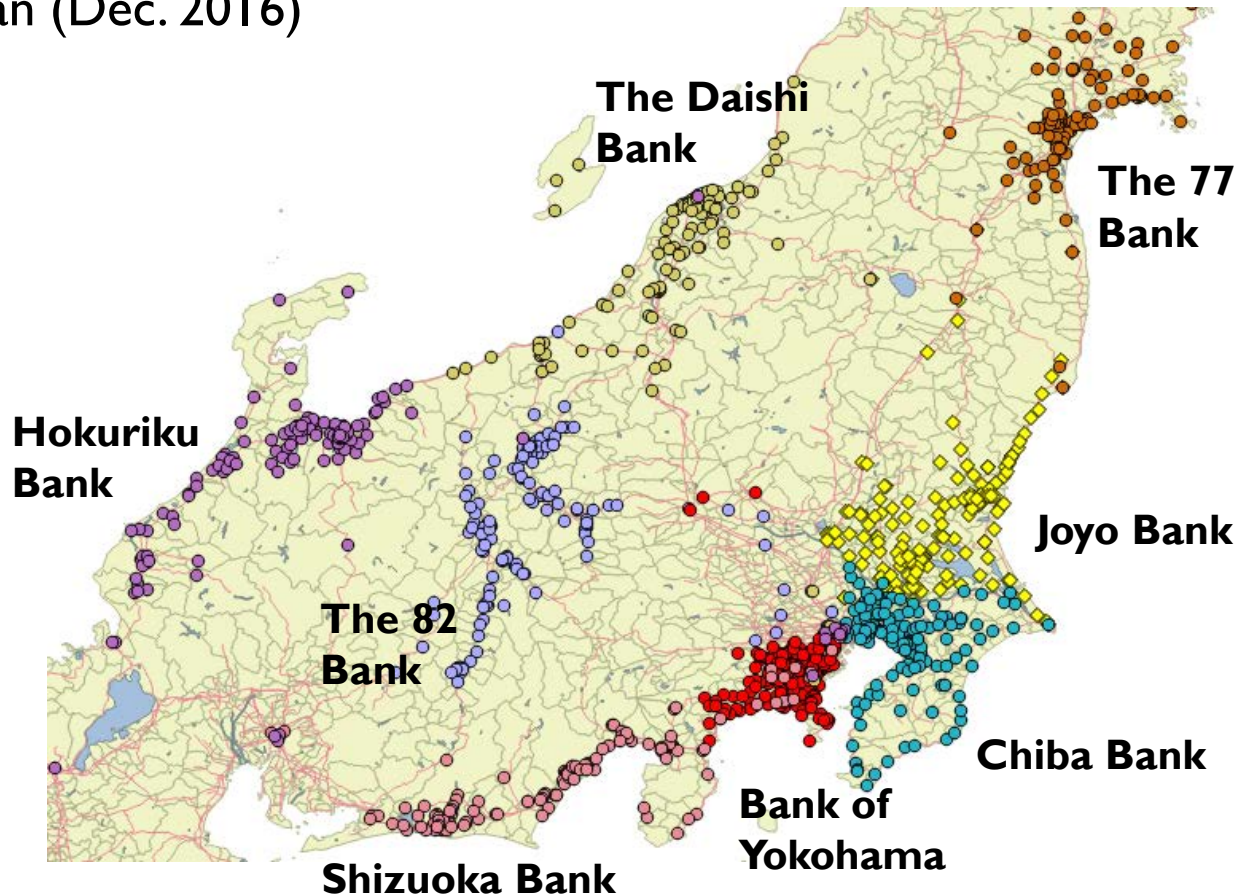
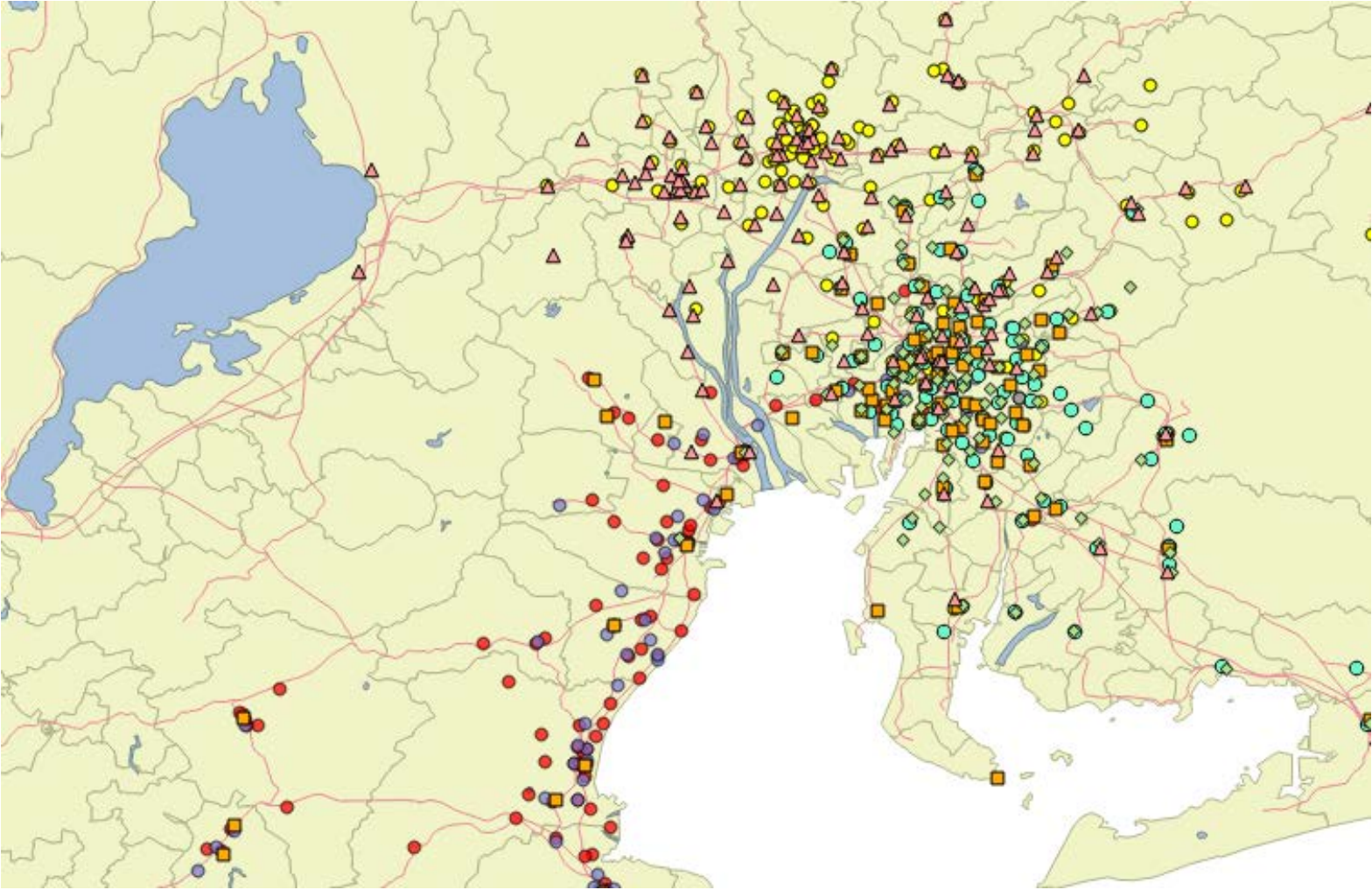




Figure. Regional Bank Branch Geographical Distributions in Central Japan (Dec. 2016)



- The 105 Bank
- Dai San Bank
- Bank of Nagoya
- Chukyo Bank
- Aichi Bank
- The 16 Bank
- ▲ Ogaki Kyoritsu Bank

# VI. Comment 5: Does Bank Merger Wave Improve Operational Performance?

- Existing literature asserts that bank consolidation automatically promotes cutting off existing SME borrower clients. (Sapienza, 2002; Krcek et al., 2005)
- The literature also asserts that a bank merger improves the performance of the acquiring bank. (Barucci & Mattesini, 2008)

|  | Country<br>(Sample<br>Period) | Bank Consolidation Consequences |                     |                               |                                |                                  |                                 |
|--|-------------------------------|---------------------------------|---------------------|-------------------------------|--------------------------------|----------------------------------|---------------------------------|
|  |                               | SME<br>Borrowers                | Client<br>Borrowers | Acquired<br>Bank<br>Borrowers | Acquiring<br>Bank<br>Borrowers | Acquiring<br>Bank<br>Performance | Acquired<br>Bank<br>Performance |
| <b>Sapienza(2002)</b>                            | Italy<br>(1989-95)            | Negative                        |                     |                               | Positive                       |                                  |                                 |
| <b>Krcek, Ongena &amp; Smith(2005)</b>           | Norway<br>(1983-00)           | Negative                        |                     |                               | Positive                       |                                  |                                 |
| <b>Degryse, Masschelein &amp; Mitchell(2005)</b> | Belgium<br>(1992-03)          |                                 |                     | Negative                      | Positive                       |                                  |                                 |
| <b>DiPatti &amp; Gobbi(2007)</b>                 | Italy<br>(1990-99)            |                                 |                     | Negative                      | Positive                       | Positive                         | Negative                        |
| <b>Barucci &amp; Mattesini(2008)</b>             | Italy<br>(1994-00)            |                                 |                     |                               | Positive                       | Positive                         |                                 |

# VII. Concluding Comments

- The diminishing loan–deposit interest rate margins deteriorate bank performance, but new business model adoption is not always easy.
- Japanese banks have room to increase non-interest revenues from retail markets, but this requires the reconsideration of existing bank strategies and increases in both fixed and R&D investments.
- Even after the bank branch deregulation of 1998, a regional border effect negatively influences regional bank performance in Japan. This is because regional banks have a significant number of lending relationships with poor performing SMEs.
- An enhancement of SMEs' operational performance and an increase in regional bank profitability are in trade-off and cannot be achieved simultaneously.
- Although regional bank consolidation often increases the lending relationship cut-off, it improves the profitability of the acquiring bank.

# Reference

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