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BOJ's new IOER top-up program's aims and likely outcomes

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Executive Summary

In March, the BOJ launched a new deposit facility that pays an extra 10bps of annual interest on qualifying regional financial institutions' excess reserves held at the BOJ. The program aims to better align BOJ policy with government policy and soften the BOJ's NIRP. It should incentivize regional financial institutions to cut overhead expenses.

BOJ nudging regional banks to get back on sounder footing

On March 1, the BOJ launched a special deposit facility that pays an extra 10bps of interest on excess reserves (IOER) to promote systemic financial stability by helping regional financial institutions to shore up their foundations.

Qualifying regional financial institutions will earn an extra 10bps p.a. on their excess reserves on deposit at the BOJ. Under the BOJ's current IOER regime adopted in January 2016, excess reserves are stratified into three tiers. The bottom tier earns interest at +10bps p.a. while the top tier is charged negative interest at the BOJ's IOER policy rate of –10bps. The middle tier has an IOER rate of 0bps. The extra +10bps of IOER available from the new deposit facility, a three-year (FY20-22) program, would negate the negative rate charged on the top tier, thereby improving the eligible financial institutions' earnings to some extent.

To take advantage of the new facility, regional financial institutions must first be committed to contributing to sustained development in their regional economies. In addition to this vague requirement, they must also (1) reduce their overhead expenses or improve their overhead ratio (OHR) by a certain amount (the OHR requirement) or (2) seek to strengthen their operational foundations through

New BOJ deposit facility's OHR requirement

	FY20	FY21	FY22
Reduction in OHR	≥ 100bps	≥ 300bps	≥ 400bps
Reduction in OH expenses	≥ 2%	≥ 4%	≥ 6%

Note: The tabulated reductions are relative to FY19 values. OHR = overhead expenses ÷ gross business profit

Source: BOJ, Overview of the "Special Deposit Facility to Enhance the Resilience of the Regional Financial System" (December 25, 2020) industry consolidation (the consolidation requirement). The OHR requirement is detailed in the accompanying table.

In sum, the BOJ will promote regional economic revitalization and systemic financial stabilization for three years by incentivizing financial institutions to solidify their foundations by lowering their breakeven points (OHRs) and/or merging with each other.

New deposit facility will not accelerate banking sector consolidation

We surmise the BOJ has two main objectives in rolling out the new deposit facility at this time. The first is to coordinate more closely with government policy. The second is to adjust–i.e., normalize–monetary accommodations that have hurt regional financial institutions' earnings.

One of the requirements to be eligible to earn the extra IOER is consolidation among financial institutions. Adoption of a policy that promotes M&A in the financial sector may seem like BOJ mission creep, but the move was more likely intended to sync BOJ policy with the government policies described below than to spur M&A on the BOJ's own accord.

Effective November 2020, the government amended the Antimonopoly Act for a 10-year period to facilitate M&A between regional banks located within the same prefecture. Additionally, it plans to further incentivize consolidation among regional financial institutions by establishing a subsidy program this summer. The subsidy program is slated to defray regional financial institutions' IT system integration costs incidental to M&A, up to a maximum of ¥3bn per deal.

During the pandemic, the BOJ has been more cognizant than usual of coordinating policy with the government. This shift reflects that the BOJ has few if any remaining options to ease further and now must be more mindful of side effects of its monetary easing. The BOJ launched a program to provide extra funding to financial institutions to peripherally support a government lending program to aid companies hard hit by the pandemic. As long as the BOJ remains committed to supporting companies and their employees through policy coordination with the government, it should be insulated against criticism for, e.g., failing to achieve its +2% inflation target. The new special deposit facility could be seen as phase two of BOJ policy coordination with the government, with the first phase being the aforementioned special funding program.

Additionally, the new deposit facility could be regarded as a sort of subsidy for regional financial institutions plagued by an adverse earnings environment due to the BOJ's monetary accommodation, most notably its negative interest rate policy (NIRP). Its subsidy-like nature is another point in common with the special funding program, which lends to banks at an effectively negative interest rate. If such BOJ programs lead to improvement in financial institutions' earnings and financial condition, they should have positive knock-on effects on bank lending and, in turn, economic activity. They are de facto normalization policies that mitigate the enfeeblement of banks caused by the BOJ's unconventional monetary easing to date.

The new deposit facility sends a message that the BOJ is heavily prioritizing its systemic financial stability mandate over its price stability mandate in response to the pandemic. From such a perspective, we can safely conclude the BOJ is now less likely to lower its IOER policy rate further below the zero bound, a move that would likely trigger another leg down in regional financial institutions' earnings.

Of the new deposit facility's two requirements, the OHR requirement is more important than the consolidation requirement in terms of influencing regional financial institutions' behavior. Even without nudging from the BOJ, all regional financial institutions continue to routinely work on cutting overhead expenses. However, if they can earn extra IOER from the BOJ, they are better off taking advantage of the opportunity. Even if unable to meet the OHR requirement in both FY20 and FY21, regional banks can earn the full three years' worth of extra IOER by meeting the OHR requirement in FY22. They are therefore likely to tenaciously devote themselves to overhead cost-cutting through FY22.

In terms of the consolidation requirement, we doubt many regional financial institutions will start to pursue M&A just to qualify for the extra IOER. Even if all regional and *shinkin* banks were to hypothetically qualify for the extra IOER, their annual IOER income would increase by only ¥40-50bn in aggregate. Even for the biggest regional bank, the extra IOER would be less than ¥10bn per year. For long-standing regional banks, M&A is a momentous decision with major ramifications for the local economy and local industries. We doubt the extra IOER available from the BOJ's new deposit facility would be sufficient to incentivize

M&A. In sum, while the new deposit facility should strongly motivate regional financial institutions to pursue overhead cost-cutting, it is unlikely to materially influence M&A decisions.

History has shown that M&A alone is not a magic bullet for what ails regional financial institutions. Recently, some regional financial institutions have been successfully expanding their businesses and cutting overhead expenses through alliances instead of M&A. It is incumbent upon every financial institution to explore all available means to strengthen their foundations and select whichever is the best fit for its situation. Any financial institution that determines that M&A is the most effective means should take utmost advantage of the BOJ’s new deposit facility and government incentives. Such financial institutions presumably will in fact do so. For financial institutions, the key to sustained growth going forward is having the acumen and decisiveness to choose a growth model that is a good fit.

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