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Regional bank consolidation will not solve Japan's deposit glut problem

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Executive Summary

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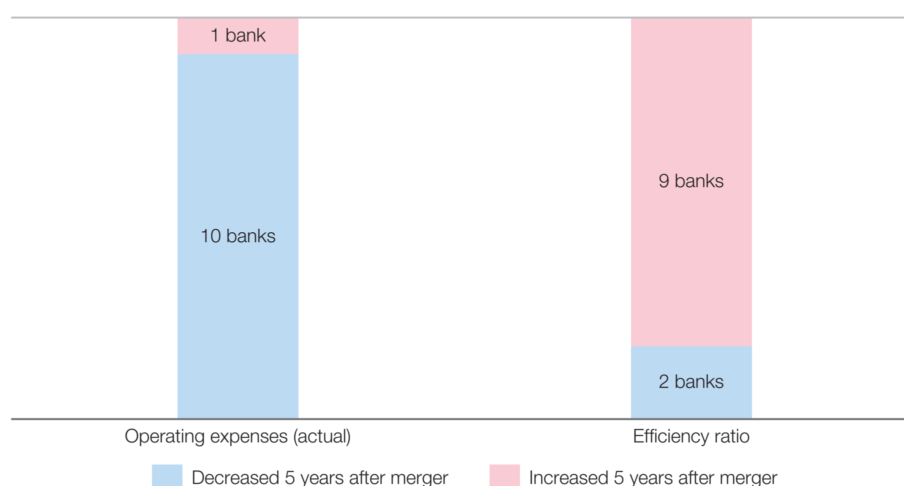
The Japanese government is preparing to enact legislation to promote consolidation among regional banks. While such legislation would be a key step toward rectifying Japan's overpopulation of banks, Japan's deposit glut is a more serious problem from a long-term perspective.

Legislation to promote regional bank consolidation is in the works

A draft growth strategy action plan unveiled on June 5, 2019, by the Japanese government's Council on Investments for the Future recommended measures to facilitate mergers among regional banks. The government is expected to enact legislation that would carve out an antitrust exemption to make it easier for regional banks to merge. Though the specifics have yet to be fleshed out, such legislation would definitely be a major step toward rectifying Japan's chronic overbanked status.

However, even if the government promotes regional bank consolidation, it is not a panacea for regional banks' problems, many of which would persist after consolidation. One big question is the extent to which consolidation would

Exhibit: Post-merger changes in operating expenses and efficiency ratios



Notes: Based on comparisons of financial statement data immediately preceding merger versus five years after merger. Efficiency ratio is operating expenses divided by gross business income. Pre-merger operating expenses and gross business income are arithmetic sums of the merged banks' respective pre-merger operating expenses and gross business income. Gross business income is the sum of net interest income, net fees and commissions and net trading income.
Source: NRI, based on Japan Bankers Association's Financial Statements of All Banks

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improve regional banks' operating efficiency. The graph (page 1) shows how the operating expenses and efficiency ratios (ratio of operating expenses to gross business income) of 11 regional banks formed by mergers since 2000 changed over their first five post-merger years. In 10 of 11 cases, operating expenses were reduced, presumably mainly as a result of non-personnel cost-cutting through such means as closing duplicative branches and otherwise downsizing real estate footprints. Efficiency ratios, by contrast, increased in nine of the 11 cases. Given the reduction in operating expenses in the ratio's numerator, the increases in efficiency ratio must be almost entirely attributable to reduction in the denominator, gross business income.

The Council on Investments for the Future's discussions to date have been predicated on the assumption that consolidation would make the regional banking industry more efficient. For example, the Council has asserted that regional banks have substantial scope to reduce overhead expenses through consolidation because fixed expenses, most notably IT system expenses, account for a large share of their costs. Another such assertion is that industry consolidation would give regional banks more wherewithal to keep fulfilling financial intermediation functions. Previous mergers, however, suggest that although regional banks have substantial scope to reduce overhead expenses, such cost-cutting does little to drive earnings growth. Even if pro-merger legislation is enacted, regional banks will need to individually step up their management effort.

Mergers will not solve deposit glut problem

"Overbanked" has two meanings in common parlance. First, it refers to a surfeit of banks or bank branches, a problem that can be addressed by banks' management decisions, including consolidation.

The second meaning is a systemic glut of deposits, a problem facing all banks and other depository financial institutions in aggregate, not individually. Japan's deposit glut seems to be a more serious problem than bank overpopulation because the total stock of bank deposits will likely continue growing irrespective of individual banks' management efforts.

Broadly speaking, deposits originate from two sources: bank lending and government bond issuance. In the former case, deposits are created whenever a bank funds a loan to a company, an individual or the government. This mechanism

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is called “credit creation” in finance and economic textbooks. With government bond issuance, deposits are created only when the government spends the proceeds. Bond issuance to refund maturing bonds does not create deposits. When the government spends money, the spending is of course disbursed to companies and households, which receive the payments from the government in the form of deposits into their respective bank accounts. New fiscal spending consequently increases the stock of deposits. While the resultant growth in deposits may not be called “credit creation,” it is essentially identical to credit creation in that new deposits are generated concurrently with an increase in a non-bank entity’s liabilities.

In sum, the total stock of bank deposits increases or decreases as a function of two variables: total bank loans outstanding and the government’s primary fiscal balance. If we assume that bank loans outstanding will grow at the same rate as the economy and the primary fiscal balance will remain in deficit to some extent, the total stock of deposits would continue to grow.

While such crude assumptions’ validity may be debatable, the important point is that the economy’s growth rate and especially the fiscal deficit, the two main drivers of changes in the total stock of deposits, are both beyond the control of individual banks’ management. If fiscal deficits continue to drive growth in deposits, two difficulties will arise for banks over the long term.

First, with deposit rates already at rock-bottom levels, the total interest charges that banks pay on deposits will eventually start increasing as a result of deposit growth. When deposit insurance premiums also are factored in, incoming deposits will progressively increase banks’ costs year after year. Banks would be hard-pressed to offset such cost increases unless loan demand growth outpaces growth in deposits.

Second, the gap between banks’ deposits and outstanding loans would continue to widen, leading to continued growth in banks’ aggregate holdings of securities, particularly higher-risk securities. Overexposure to risky securities could end up destabilizing the financial system or impeding financial intermediation. To reiterate, such an outcome would occur irrespective of how many banks there are. Even if the number of banks were hypothetically halved by mergers, the systemic risk posed by continued growth in risky securities holdings would remain unchanged.

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Addressing these problems is beyond the purview of banks' management, at least on the individual bank level. Such being the case, the government and regulatory authorities' role will likely become more important. The Financial Services Agency is currently spearheading measures to promote household wealth building. The campaign is spot on in terms of its objective but current tax incentives and initiatives to promote household investment in risk assets are insufficient. The measures should be revised to incorporate the big-picture perspective of rectifying imbalances in macro capital allocations. Additionally, we depositors may need to adopt a new mindset. We should perhaps discard the conventional notion of free deposit accounts and bear the cost of maintaining them.

Japan's overbanked status in the deposit glut sense may not rank very high on the government's current policy agenda, given the low likelihood of it becoming an urgent problem in the near future. Over the long term, however, it will likely prove to be a very real problem.

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