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Impact of rising interest rates on bank spreads

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Many analysts have argued that prospective increases in short-term interest rates will enhance banks' loan-to-deposit spreads. But a number of other issues must be taken into account. Depending on how depositors react, for example, higher rates may have unexpected results for banks.

End of quantitative easing and beyond

The Bank of Japan has ended the policy of quantitative easing, an emergency measure unprecedented in the history of central banking. With its demise, the Bank will finally revert to the "peacetime" use of interest rates as a policy instrument. Eventually it is likely to consider raising short-term rates.

Recently many analysts have argued that a rise in short-term rates will impact favorably on banks' core earnings from loans and deposits. They cite growth in spread lending, which is tied to short-term interest rates, and demand deposits (ordinary savings and checking accounts), which have relatively low interest rate sensitivity.

But two points should be kept in mind. First, spread lending's share of total lending varies significantly by bank category. Second, depositors who grew accustomed to ultra-low interest rates may change their behavior as rates start to rise. This report takes a closer look at these issues.

Ratio of spread lending varies by bank category

Adjustable-rate loans are estimated to account for some 70–80% of total lending at city banks and first- and second-tier regional banks. But spread lending's share of this category varies markedly. Based on a variety of data, we estimate that spread lending represents about 40% of total lending at city banks but only about 10%, on average, of lending by first- and second-tier regional banks.[1] We attribute this disparity to the fact that city banks tend to deal with large corporations that are sensitive to interest rates, while regional banks' main customers are mostly smaller businesses.

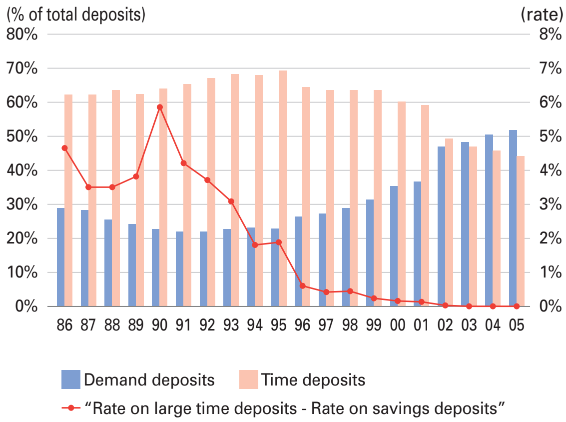
Other adjustable-rate loans are generally based on the short-term prime rate, which each bank sets for itself. Many regional banks have left this key rate unchanged since the adoption of quantitative easing and zero interest rates, making it difficult for them to raise loan rates even if market rates were to increase.[2]

In summary, city banks and regional lenders would benefit to different degrees from higher loan rates.

Depositor behavior may also change as rates rise

An analysis of bank deposits confirms that demand deposits—ordinary savings and checking accounts—now account for a historically large share of total deposits. Exhibit 1 shows demand deposits and time deposits as a

Exhibit 1. Breakdown of bank deposits and deposit rates



Source: NRI, based on Bank of Japan data and Japanese Bankers Association's *Analysis of Financial Statements of All Banks* percentage of total deposits along with spread between the rates offered on savings and time deposits (for the latter we used the rate on large, one-year deposits).

A pronounced shift from time deposits to demand deposits began in the second half of the 1990s as the Bank of Japan lowered interest rates and reduced the yield spread between the two. Today more money is held in demand deposits.

This trend was given added impetus by concerns about the creditworthiness of banks and the government's decision to end blanket deposit insurance. But now concerns about the financial system have largely faded. If the spread between yields on demand deposits and time deposits reaches a certain level, interest-rate-sensitive depositors may begin to transfer surplus funds from demand deposits to time deposits or even to investment trusts or other assets.[3] When the shift from time to demand deposits began in 1996, the yield spread was about 0.5 point and the uncollateralized overnight call rate stood at 0.5%. Accordingly, just two 25bp rate hikes would be sufficient to bring the policy rate back to this level.[4]

Incidentally, demand deposits' share of total deposits is about 10 points higher at city banks than regional banks, which would therefore experience a greater rise in funding costs if money shifted back to time deposits.

Impact of changes in funding structure

Many financial institutions are said to be drawing up their medium-term business plans, which require forecasts of interest rates and earnings. Changing depositor behavior may be the most difficult factor to project and build into such plans, in our view. During the prolonged period of ultra-low interest rates, many banks focused exclusively on the lending side of the business and gave little thought to funding issues.

Exhibit 2 presents a rough estimate of the change in loan-to-deposit spreads that would occur if the short-term prime rate and spread lending's share of total lending remained at current levels but short-term interest rates, deposit rates, and the deposit mix suddenly reverted to the conditions of 1996, when the shift from time to demand deposits began. (The loan-to-deposit spread is defined as the average loan rate less (1) the expense ratio for labor costs, branch costs, and other expenses and (2) the cost of deposits and other sources of funds.) While this is an extreme scenario, we estimate that loan-to-deposit spreads at all three categories of lenders would drop by about 60%.

Exhibit 2. Impact of rising deposit costs on loan-to-deposit spreads

	2005 H1	Test scenario	% decline
City banks	0.68%	0.30%	-56%
First-tier regional banks	0.78%	0.25%	-68%
Second-tier regional banks	0.95%	0.37%	-61%

Source: Figures for 2005 H1 based on Japanese Bankers Association's *Analysis of Financial Statements of All Banks*

In the past, banks were able to widen loan-to-deposit spreads even as loan rates fell by cutting costs.[5] But the increase in costs resulting from higher deposit rates and a change in the funding mix could easily wash away these hard-won gains.

Banks need to revamp funding strategies

Banks now face a period during which the policy rate will be raised after a long period of ultra-low rates. Although the shift from time deposits to demand deposits took about eight years, we should not rule out the possibility of an unexpectedly rapid movement of depositors' excess funds to time deposits and other relatively high-cost sources of funding. Along with lending and investment operations, the ability to raise funds efficiently is expected to play a major role in determining bank earnings going forward.

Regulations on bank agencies were relaxed just this month, enabling banks to raise funds and expand sales channels at lower cost. Some lenders are already trying to retain depositors by offering enhanced services rather than higher deposit rates.[6)]

Banks need to remember that recent strong earnings are attributable not only to restructuring efforts and lower credit costs during the recovery, but also to the sacrifices made by depositors during the long period of ultra-low interest rates, and review their funding strategies accordingly.[7)]

Note

1) Estimate based on data presented in a 7 March 2006 Standard & Poor's report and a 16 March 2006 *Nihon Keizai Shimbun* article.

2) While the city banks have a short-term prime rate of 1.375%, many regional lenders have left this key rate at 1.875%.

3) According to a 10 March 2006 article in the *Nikkei Business Daily*, half the respondents to a survey of e-mail magazine readers said that they would increase their investments in marketable securities now that the Bank of Japan had ended quantitative easing.

4) As of 17 March 2006, euroyen interest rate futures were pricing in two rate hikes by the end of the year.

5) Loan rates at banks nationwide fell 0.31 percentage point over the past five years, but this decrease was more than offset by reduced deposit rates and cost-cutting efforts. As a result, the average loan-to-deposit spread actually improved by 0.14 percentage point. All calculations based on the Japanese Bankers Association's *Analysis of Financial Statements of All Banks*.

6) Bank of Tokyo-Mitsubishi UFJ, for example, has abolished fees charged on transfers between BTMU accounts.

7) The Bank of Japan estimates that if interest rates had remained at 1991 levels through 2004, household interest income would have been some 304 trillion yen greater than it was.

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