

# Strategy Review

Key events in the financial world in fiscal 1990 have been further relaxation of interest rates and further steps toward reform of the financial system—notably a partial lowering of the barrier between banks and securities firms. These changes, together with the steep decline of stock prices and higher interest rates, have forced banks and securities firms alike to review their financial strategies and to reexamine the very basics of their business management.

Interest rates were the focus of intense activity in fiscal 1990. The minimum deposit amount of small-lot money market certificates (MMCs) was lowered to ¥1 million from ¥3 million in April 1990. Interest rates on time deposits, meanwhile, are due to be completely liberalized between the spring and fall of 1993. The Ministry of Finance is also studying a timetable for liberalization of interest rates on liquid deposits, including ordinary deposits.

As of March 1990, deposits with regulation-free interest rates accounted for 49.6% of all types of deposits at commercial banks, regional banks, secondary regional banks (formerly mutual loan and savings banks) and credit associations. Regulation-free financial instruments, including bills and call money, accounted for 55.7% of total bank funds.

In the area of financial system reforms, the Financial System Council of the Ministry of Finance recommended, in an interim report in June 1990, a new formula enabling banks and securities firms to

form subsidiaries through which they could pursue business in each other's traditional domains.

Besides these structural reforms, Japan's financial institutions had to face an increasingly hostile business environment in 1990, especially because of a sharp rise in interest rates and a sharp drop in stock and bond prices. Banks suffered sharply reduced margins because they failed to pass on their higher borrowing costs in the form of higher rates of interest on loans. For the first time ever, banks felt the pain from "liberalized interest rates."

Nor were securities firms left unscathed. They saw profits plunge dramatically, along with stock prices, amid high interest rates, political uncertainty overseas and soaring crude oil prices which created profound nervousness throughout the economy. The plight of the securities firms was compounded by the huge costs of payrolls, computer systems and branch office networks, all of which had been expanded during the recent boom year.

The stock market crash has also made it harder for banks to meet capital adequacy standards set by the Bank for International Settlements (BIS). Under BIS rules adopted in late 1987, banks in industrial countries must possess capital equal to 8% of all risk-weighted assets by March 1993. When stock prices were booming, Japanese banks tried to meet the BIS standard by raising funds on the stock market, expanding the unrealized value



Japan's financial institutions faced an increasingly hostile business environment in 1990.

Photo: Nihon Keizai Shinbun

of their portfolios and building up assets. The current climate—high interest rates and low stock prices—has required banks to adopt a new strategy based on reducing total assets. Both banks and securities firms have had to seriously reexamine old business strategies based on the assumption of permanently rising stock prices.

In fiscal 1991, interest rates will likely remain high and stock prices low, forcing banks and securities firms to continue their uphill battle.

Closest on the horizon are further relaxations of interest rate regulations—sure to erode banks' profits further. The minimum deposit amount of small-lot MMCs will also be further lowered to ¥500,000 in April 1991. The latter move may further increase banks' reliance on regulation-free instruments in fund-raising. Secondary regional banks and credit associations will be the hardest hit, and they may well face the difficult task of flexibly revising interest rates on borrowers, cutting expenses wherever possible, and seeking merger opportunities in order to enjoy economies of scale. Securities firms will likely face equally unpleasant tasks, watching profits dwindle even as payroll and other costs remain high.

The coming year will see continuing efforts at financial market reform in Japan, aimed at achieving smooth integration with the financial markets of the European Community, at easing business regulations between states and at reviewing the barriers between the banking and securities industries in the United States.

(Ken Niimura, economist)

Ratio of Regulation-free Deposits at Banks

(percentage point)

	1987	1988	1989	1990
Commercial banks	23.9	35.8	44.7	58.2
Regional banks	13.7	21.4	31.5	48.6
Secondary regional banks	17.3	23.4	31.4	46.1
Credit associations	3.5	9.5	16.2	31.0
All banks	16.9	26.1	34.8	49.6

Notes: 1. The ratio of large-lot time deposits, MMCs, small-lot MMCs, nonresident deposits, foreign currency deposits and transferable time deposits to all types of deposits held by banks.

2. Figures are for the end of March each year.

Source: Economic statistics monthly, Bank of Japan