

2. Sustaining Japan's Regional Banks' Profitability amid Medium-term Tailwinds and Long-term Headwinds ⁹²

Overview

Regional banks ⁹³ low profitability has been a longstanding issue due to a changing demographic structure and their close links with regional economic vitality. In light of monetary policy normalization and the government's regional revitalization initiatives, this selected issue assesses the impact of the current interest rate upcycle and medium- to long-term structural issues on regional banks. Policy implications are discussed while considering lessons learned from the various measures and initiatives already implemented.

Background

1. Regional banks have faced pressures owing to structural issues and struggled with low profitability. In particular, shrinking population and aging are long-term challenges for potential growth and economic vitality, which impacts regional banks' profitability.⁹⁴ Several measures that can directly and indirectly benefit regional banks have been implemented. For instance, while authorities have encouraged regional banks to improve profitability and diversify their sources of profits, other policies that could potentially benefit regional banks include the BOJ's monetary policy normalization and further regional revitalization efforts by the government (Regional Revitalization 2.0).⁹⁵ Over the medium-to long-term, regional banks and regional economies⁹⁶ should prosper in tandem, in order to maintain effective financial intermediation and thus, financial stability.

Tailwinds from the Interest Rate Upcycle

2. Regional banks will likely benefit from the current interest rate upcycle, albeit to a lesser extent than city banks. The financial results of major and regional banks as of September 2024 showed that net interest income increased by 14.8 percent over a year ago, following a rise in loan interest rates and increasing loan volumes as the economy continues to recover.⁹⁷ While net interest income is affected by various factors such as banks' loan and securities portfolios, and different mix of loan interest rates, the interest rate pass-through from the policy rate to loan interest rates will likely push up net interest income across banks given the lags of interest rate repricing.⁹⁸ That said, regional banks may not fully benefit from the rate upcycle. While the interest rates on JPY-denominated loans for regional banks have been higher than those for city banks (Figure A2.1), the loan beta for regional banks (an indicator of the percentage pass-through of changes in loan interest rates to changes in market interest rates) shows that regional banks have transmitted rising market rates to loan interest rates less than city banks (Figure A2.2). Given the high correlation of loan interest

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⁹³ In this selected issue, "regional banks" refers to Japanese banks, consisting of member banks of the Regional Banks Association of Japan and those of the Second Association of Regional Banks, unless otherwise stated. The member banks of the Second Association of Regional Banks are referred to as regional bank II, most of which were converted from mutual savings banks to ordinary commercial banks. Regional banks, of both associations for clarification, typically serve individuals and smaller companies within their regional customer bases in Japan.

⁹⁴ For more details, see Nakaso (2017) and AMRO (2024).

⁹⁵ See Ishiba (2024).

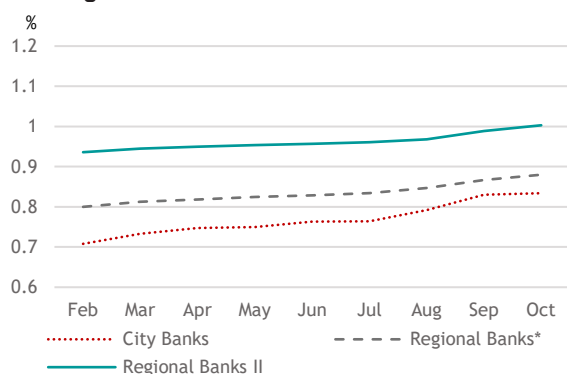
⁹⁶ Throughout this selected issue, "region" refers to local areas at a municipal and/ or prefectural level in Japan, unless otherwise stated.

⁹⁷ Major and regional banks improved by 18.7 percent and 9.0 percent, respectively, according to the FSA. Major banks consist of Mizuho Financial Group, Mitsubishi UFJ Financial Group, Sumitomo Mitsui Financial Group, Sumitomo Trust Holdings, Resona Holdings, SBI Shinsei Bank, and Aozora Bank.

⁹⁸ Due to lags of interest rate repricing, interest rate pass-through to loans on an amount outstanding basis tends to be slower than that to deposits. In the previous rate upcycle during 2006 and 2007, the loan beta (an indicator of the percentage pass-through of changes in loan interest rates to changes in market interest rates) for domestic banks had been higher than the ordinary deposit beta (an indicator of the percentage pass-through of changes in ordinary deposit interest rates to changes in market interest rates) from October 2006, following the BOJ's rate hike from around 0 percent to around 0.25 percent in July 2006, to September 2008, when the rate upcycle turned into downcycle. In the current rate upcycle from 2024, the loan beta went above the ordinary deposit beta in October 2024 as the latest data point. While the interest rate transmission needs to be monitored going ahead, this will likely lead to an increase in net interest income.

rates with the net interest margin for regional banks (Figure A2.3), if lower loan betas continue, regional banks may only improve their profitability modestly.⁹⁹

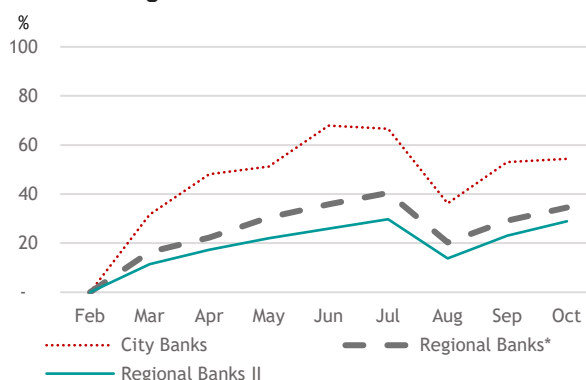
Figure A2.1. Loan Interest Rates in 2024



Source: BOJ; Haver Analytics

Note: Data covers JPY-denominated loans on the banking book except for those to financial institutions. It covers loans to both residents and non-residents. City banks consist of Mizuho Bank, MUFG Bank, Sumitomo Mitsui Banking Corporation, Resona Bank, and Saitama Resona Bank. Regional Banks* are member banks of the Regional Banks Association of Japan, and Regional Banks II are member banks of the Second Association of Regional Banks in the above figure.

Figure A2.2. Loan Beta in 2024



Source: BOJ; Haver Analytics; AMRO staff calculations

Note: Loan beta is the percentage pass-through of the increase in banks' loan interest rates to changes in the uncollateralized overnight call rate.

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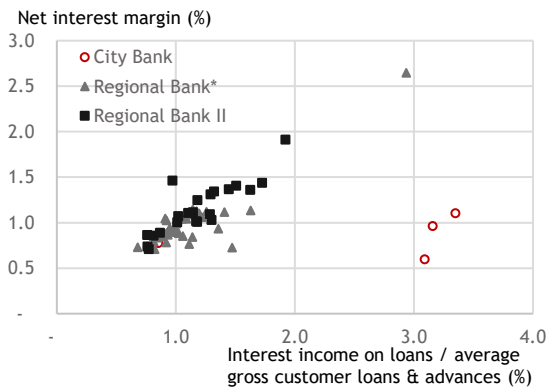
3. It is uncertain whether the positive impact on profitability from interest rate hikes can sufficiently compensate for the negative impact from structural headwinds.

Regional banks' profitability depends more on net interest income than city banks (Figure A2.4). In the last decade, many regional banks have enhanced cost efficiency (Figure A2.5) and diversified sources of profit to increase net fees and commission income (Figure A2.6). However, profitability is more uneven across regional banks than it was a decade ago. The uneven distribution of profitability among regional banks could become more pronounced during the interest rate upcycle without coping with structural headwinds from the shrinking and aging population. Less profitable regional banks, without sufficiently benefiting from the interest rate upcycle, could either reduce their lending or take more risks, potentially hampering the current effective financial intermediation. While regional banks should properly address bank-specific challenges, such as competitiveness, the central and local governments also need to cope with policy issues arising from the region-specific challenges, including a shrinking and aging population and regional economic vitality.¹⁰⁰

⁹⁹ Profitability for regional banks could improve less than the previous rate upcycle during 2006 and 2007. BOJ (2024) showed that SMEs have been networking more with regional banks, and assessed that as the competitive environment in regional loan markets overall appears to be more severe, it may be difficult for some regional banks to raise loan rates to the same extent as during the previous upcycle.

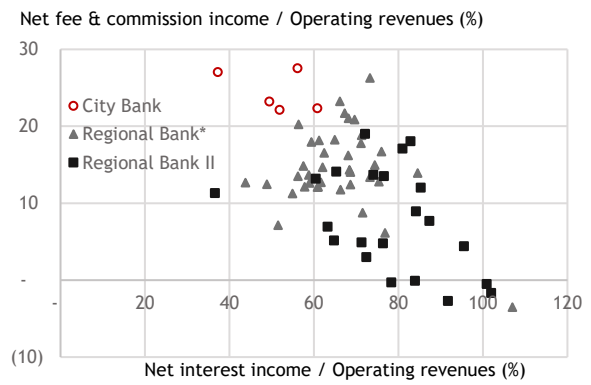
¹⁰⁰ Nakaso (2017) pointed out that the government's growth strategy to raise the potential growth rate plays a vital role in fostering financial stability.

Figure A2.3. Net Interest Margin and Interest Income on Loans in 2023



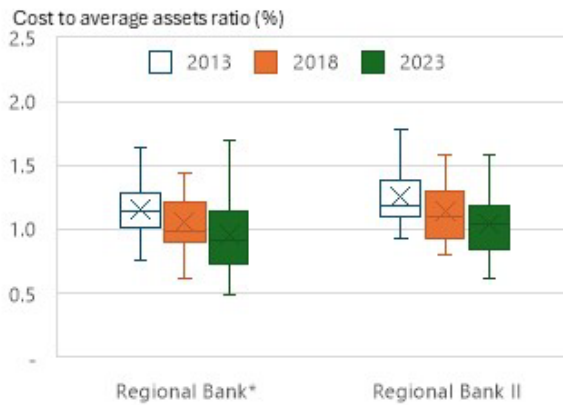
Source: Moody's
Note: Regional Banks* are member banks of the Regional Banks Association of Japan and Regional Banks II are member banks of the Second Association of Regional Banks in the above figure.

Figure A2.4. Net Fee and Commission Income and Net Interest Income in 2023



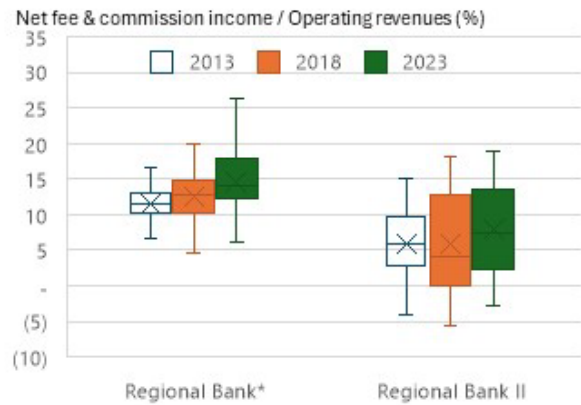
Source: Moody's
Note: Regional Banks* are member banks of the Regional Banks Association of Japan and Regional Banks II are member banks of the Second Association of Regional Banks in the above figure.

Figure A2.5. Cost to Average Assets Ratio



Source: Moody's
Note: Regional Banks* are member banks of the Regional Banks Association of Japan and Regional Banks II are member banks of the Second Association of Regional Banks in the above figure.

Figure A2.6. Net Fee and Commission Income



Source: Moody's
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Regional Banks could be Faced with Structural Challenges Resulting from Demographic Shifts

4. Japan has been facing significant demographic shifts, with profound impacts across prefectures. Japan became a super-aged society in 2007 with 21 percent of the population aged 65 years and above and the population started shrinking in 2011.¹⁰¹ By prefecture, all 47 except 7 across Japan (Tokyo, Kanagawa, Aichi, Saitama, Chiba, Fukuoka and Okinawa) have experienced declining population from 2010-2023 (Figure 2.7). In general, all with a population size of less than 3 million have tended to experience shrinking population. Second, prefectures which experienced declining population also tended to have a higher-than-average share of elderly population (aged 65 years and more) and old-age dependency ratios (Figure A2.8).

¹⁰¹ Depopulation and aging are expected to accelerate by 2050, with the overall population projected to decline by 16 to about 105 million, and almost a quarter of the population above the age of 65. Projection by National Institute of Population and Social Security Research, medium scenarios for fertility and mortality (https://www.ipss.go.jp/pp-zenkoku/e/zenkoku_e2023/pp2023e_Summary.pdf).

Figure 2.7. Population Growth and Size (by Prefecture)

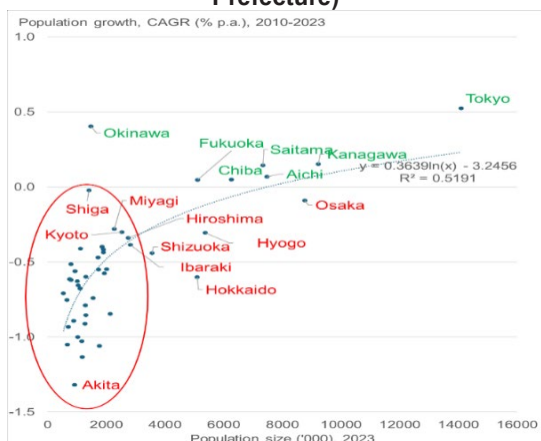
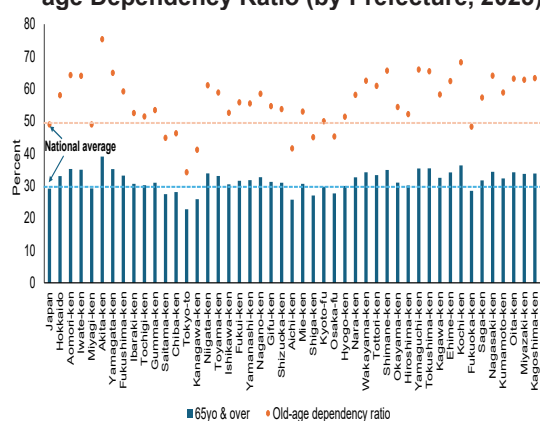


Figure 2.8. Share of Elderly Population and Old-age Dependency Ratio (by Prefecture, 2023)



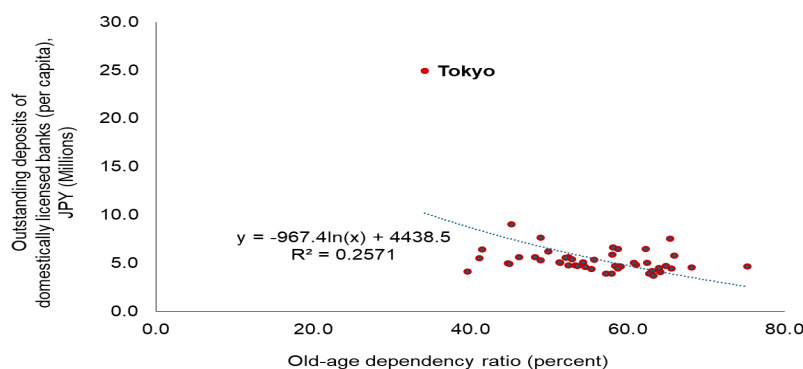
Source: Japanese Government Statistics (<https://www.e-stat.go.jp/en>).

Note: Old-age dependency ratio is computed as the ratio of elderly (aged 65 and above) to the working-age population (aged 15 to 64).

5. An aging population and shrinking population can pose structural challenges to the regional banking sector.

Rising old-age dependency ratio could exert pressure on public pension systems for future retirees, potentially necessitating a more rapid decumulation of private savings (Imam and Schmieder, 2024). Across prefectures, higher old-age dependency ratios tend to result in lower outstanding deposits of domestically licensed banks per capita. Tokyo stands out as the prefecture with the highest domestic deposit per capita and lowest old-age dependency ratio (Figure A2.9). Notably, an IMF (2017) study found that an aging population has non-linear effects on loan and deposit size per capita. Consistent with life-cycle hypothesis, per capita loan size increases as the age distribution shifts from the 20–34 age group to the reference group aged 35–54, while it falls in response to a shift from the 35–54 to older age groups. While similar pattern seems to exist for deposit growth, aging appears to have a relatively stronger impact on per capita loan size compared to per capita deposit size. In addition, declining population could shrink banks’ balance sheets and has a larger impact on loan growth relative to deposit growth. Without alternative sources and uses of funds, shrinking and aging prefectural populations could lead to smaller balance sheets and declining loan-deposit ratios in regional banks (IMF, 2017).

Figure A2.9. Outstanding Deposits of Domestically Licensed Banks (Per Capita) and Old-age Dependency Ratio (by Prefecture)



Source: Japanese Government Statistics (<https://www.e-stat.go.jp/en>).

Evolution of Regional Revitalization Strategies

6. Amid this backdrop, the Japanese government has proactively taken policy actions to spearhead regional revitalization strategies, particularly since 2014.¹⁰²

Under the then-Prime Minister Shinzo Abe, the government started promoting a “Regional Revitalization Policy” (*chiho sosei*) in 2014. The national policy has led to a significant expansion of local measures to attract residents, including support and cash incentives for relocation and housing, child-rearing and medical care, and employment and start-ups (Hijino, 2024). Coordination of local revitalization efforts has been the responsibility of a newly designated Minister for Overcoming Population Decline and Revitalization of the Local Economy, and its mission was central to the “third arrow” of Abenomics. In addition, the revitalization minister also oversaw another new government initiative, the National Special Strategic Zones (NSSZ).¹⁰³ Additionally, the Regional Economy and Society Analyzing System (RESAS) was established as an information system to compile big data and provide information support for various regional revitalization efforts.¹⁰⁴ Subsequently, in 2021, then-Prime Minister Fumio Kishida launched “The Vision for a Digital Garden City Nation”, which aims to solve rural issues and improve rural attractiveness while utilizing the strength of each region through digital technologies (OECD, 2023).¹⁰⁵

7. **While the regional revitalization policies are positive steps, they should be evaluated for their effectiveness.** The fiscal grants/ subsidies for the promotion of regional development, has amounted cumulatively to around JPY1.9 trillion or only about 0.03 percent of GDP on average per annum since the launch of the regional revitalization policy in 2014 (Figure A2.10). Surveys of utilization of grants for regional development suggest that effectiveness was adversely affected during the pandemic (FY2021 and FY2022). However, it recovered in FY2023 with 83 percent of the respondents expressing that the grants have been effectively utilized, compared to around 72 percent prior to the pandemic (Figure A2.11). Prime Minister Shigeru Ishiba’s government is currently working on a plan for rural

¹⁰² In the 1960s and 1970s, under various Comprehensive National Development Plans and fiscal decentralization, Japan managed to achieve more equitable growth across regions by developing infrastructure and regional manufacturing hubs (Fujii et al, forthcoming). Policy since the late 1990s/ early 2000s has relied on innovation and cluster policies, although infrastructure policies and tax breaks for companies that relocate some headquarters functions to the regions have remained important (OECD, 2016). In 2008, a hometown tax program (*furusato nozei*) was introduced to alleviate the disparity in tax revenues between Tokyo and other urban areas and rural municipalities (Kutty and Tochibayashi, 2023). In 2009, the government launched the Local Revitalization Cooperator (“*Chiiki Okoshi Kyouryokutai*”) initiative, a national-level rural revitalization policy, where urban residents are incentivized to move to depopulating rural communities and engage in local revitalization projects (Zollet and Qu, 2024).

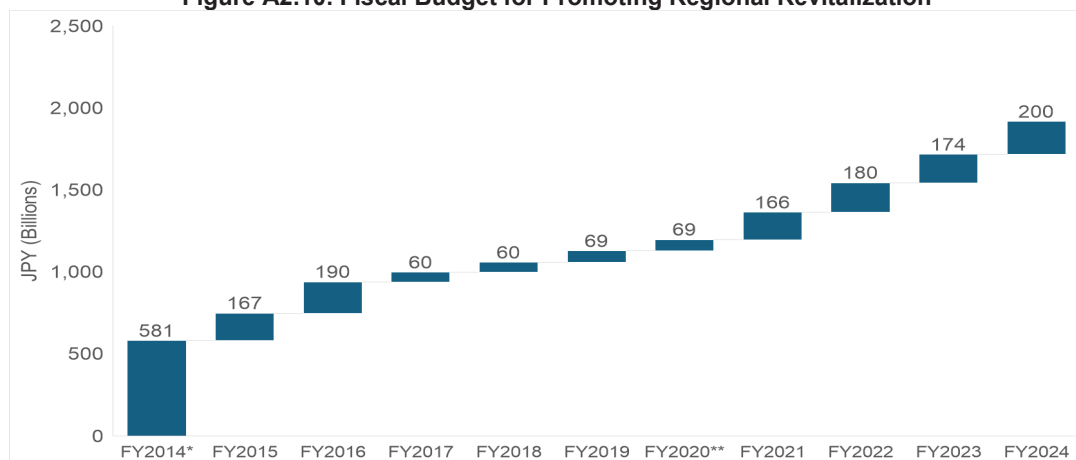
¹⁰³ The NSSZ covered six areas: Tokyo area (center for international business and innovation); Kansai area (Osaka, Kyoto and Hyogo prefectures, hub for medical innovation and human resources); Okinawa prefecture (international tourism center); Fukuoka City (promotion of start-up businesses through employment reforms); Hyogo prefecture (reform center for agriculture in mountainous regions); and Niigata City (reform center for large-scale agriculture). These NSSZs, which are intended to catalyze private sector investment, implemented regulatory reforms in urban development, education, employment, medical care and agriculture (OECD, 2015).

¹⁰⁴ The RESAS is provided by the Ministry of Economy, Trade and Industry, Small and Medium Enterprise Agency, Planning Division, Business Environment Department, and the Cabinet Secretariat, New Regional Economy and Living Environment Creation Headquarters Secretariat (<https://resas.go.jp/#/13/13101>).

¹⁰⁵ Under this vision, it is expected that the use of digital technology will solve for rural issues such as the population decline, declining birth-rates, the aging population, and the hollowing out of regional industries—for example, by promoting remote work and relocation to rural areas, establishing satellite offices and implementing remote medicine, distance education, automated driving and drones. In 2022, the Japanese government formulated a comprehensive strategy to realize this vision and it will make a concerted effort to support local governments in implementing measures to achieve their respective regional visions.

revitalization for the next 10 years, which is expected to be ready by the summer of 2025.¹⁰⁶ This is a good time to take stock of the initiatives and draw out key lessons.

Figure A2.10. Fiscal Budget for Promoting Regional Revitalization



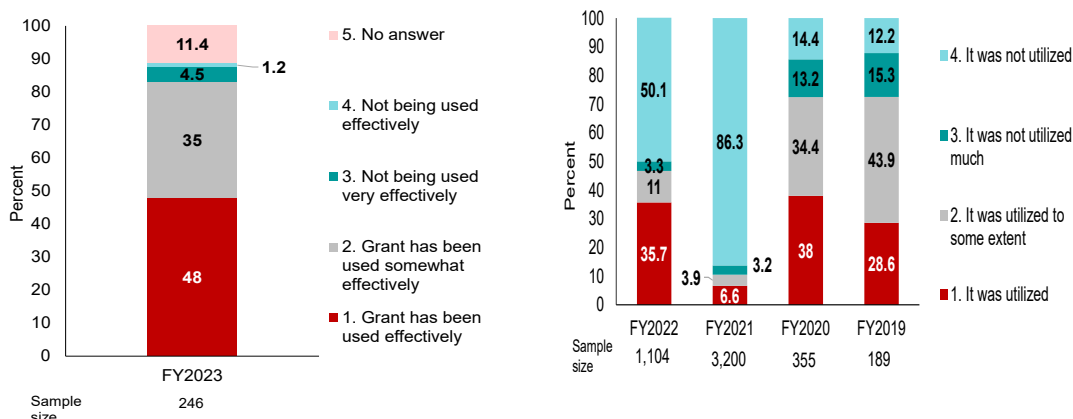
Source: Various budget documents published by the Ministry of Finance, compiled by AMRO staff

Notes: The fiscal budget estimates mainly pertained to subsidies/grants.

*Includes economic revitalization through industrial development in regions (JPY359.8 billion), advance implementation of the “Total strategy toward advancing community building, fostering human resources, and job creation” (JPY198.2 billion), and other measures (JPY23.3 billion).

** Excludes allocation for regional revitalization to cope with COVID-19 (JPY5,500 billion).

Figure A2.11. Surveys of Utilization of Grants/ Subsidies for the Promotion of Regional Revitalization



Respondents were asked whether grants were effectively utilized.

Source: <https://www.chisou.go.jp/tiiki/tiikisaisei/siryou.html>; AMRO estimates.

Notes: There was a change in survey questionnaire response options in the FY2023 survey, hence the findings might not be strictly comparable to previous years.

Policy Discussion

8. While serving as an important financial service provider rooted in the local community, regional banks should continue making efforts to enhance profitability while maintaining prudent risk management. While making use of authorities’ policy initiatives, such as the BOJ’s special deposit facility, regional banks have improved their business in the low interest rate environment. Many regional banks have enhanced cost

¹⁰⁶ A panel of experts is reviewing the regional revitalization efforts from the past decade and has exchanged opinions on the results achieved so far, and the points for reflection. The panel comprises 15 people, including former Internal Affairs and Communications Minister Hiroya Masuda, who is also the president of Japan Post Holdings; Haruka Kuwabara, mayor of the town of Tsunan in Niigata Prefecture; and young entrepreneur Mai Kobayashi (<https://www.japantimes.co.jp/news/2024/11/29/japan/japan-help-regional-revitalization/>).

efficiency and tried to diversify their business to ramp up fee earning businesses, including products and services related to business succession from one generation to the next, in addition to traditional banking services. Going forward, regional banks should continue to increase profitability as the current interest upcycle may not benefit them sufficiently to address the structural headwinds from the aging population, given the competitive environment in loan markets and the observed lower loan beta for regional banks than that for city banks. They need to adopt business models with better profitability prospects (for instance, via digital transformation and business alliance) and enhance business efficiency and risk management practices. Moreover, promoting overseas businesses could also help to improve profitability for some regional banks.¹⁰⁷

9. Financial authorities' initiatives have helped to support regional banks' business and encouraged them to continue ensuring effective financial intermediation over the long term. The FSA has aimed to maintain the provision of financial services in regions faced with structural challenges and encouraged regional banks to integrate and restructure their business typically through M&As, based on the new Antimonopoly Act. The FSA has also relaxed regulations on the scope of services in the banking sector and established the Grant Scheme for Regional Banks to support regional economies to help them overcome the impacts of COVID-19. The BOJ introduced the Special Deposit Facility (expired in March 2023) which aimed to strengthen the foundations of regional banks. These financial policies during the past years have incentivized regional banks to enhance their business efficiency and upgrade their business models. The authorities should continue to monitor regional banks given the uneven distribution of profitability and ensure effective financial intermediation.

10. Regional revitalization efforts are commendable, but a holistic approach is needed. Regional revitalization initiatives should entail a multi-pronged approach. There should be continued efforts in the following areas: i) harnessing the RESAS information system and impact evaluation of regional revitalization initiatives; (ii) strengthening coordination across ministries and government agencies at the central and local levels; and (iii) promotion of regional tourism.¹⁰⁸ In the area of fiscal incentives, there could be some room to increase grants and subsidies for the promotion of regional revitalization, which could be more targeted at prefectures that have been experiencing shrinking population and negative net migration. These prefectures include Aomori, Akita, Iwate, Nagasaki, and Yamagata (Figure A2.12). In addition, the government's immigration policy could incentivize and facilitate the inflow of immigrants to these prefectures.¹⁰⁹ Regional revitalization policies

¹⁰⁷ For example, two of Japan's biggest regional banks, Gunma Bank and Bank of Yokohama, had picked Vietnam and Singapore as locations for new offices to support client companies' expansion into the Southeast Asian region. In particular, Gunma Bank's representative office in Vietnam focuses on information gathering to provide customers back home with knowledge of market conditions and administrative procedures (Takano, 2020).

¹⁰⁸ Data from Japan National Tourism Organization suggests that overnight foreign tourists tended to concentrate in Tokyo, Osaka, Kyoto, Hokkaido, Fukuoka and Okinawa.

¹⁰⁹ For example, Australia's regional migration program incentivizes migrants to regional areas. The program consists of: (i) skilled regional provisional visas that provide a pathway to permanent residence; (ii) a skilled regional permanent resident visa;

also need to create economic growth and job opportunities to address income disparity across prefectures (Figure A2.13). Lastly, regional banks play a vital role in regional revitalization efforts. They provide funds for businesses as well as information and networks to support business development and local governments (Jige, 2016).¹¹⁰

Figure A2.12. Shrinking population and Net Migration

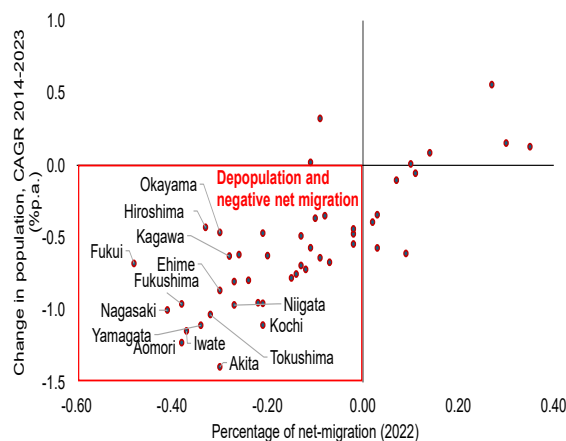
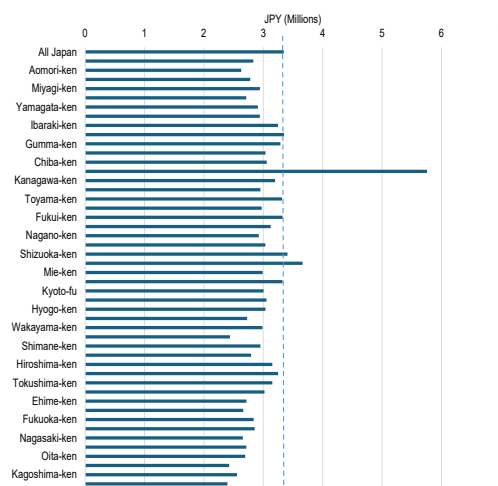


Figure A2.13. Prefecture Income per Person, 2019



Source: Japanese Government Statistics (<https://www.e-stat.go.jp/en>). Latest available data.

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(iii) additional points under the Skilled Migration Points Test for skilled migrants nominated to live and work in regional Australia; and more options for international students who graduate from regional universities. In addition, the Australian central government works closely with state, territory and local governments, and local communities, to attract migrants to regional areas. Skilled migrants settling in regional Australia have a diverse range of available occupations to match their experience, skills and qualifications (<https://immi.homeaffairs.gov.au/visas/working-in-australia/regional-migration>).

¹¹⁰ An example of prefectures and local banks in wide-ranging collaboration as the seven Setouchi prefectures (Hyogo, Okayama, Hiroshima, Yamaguchi, Tokushima, Kagawa, and Ehime), the seven local banks based there and the Development Bank of Japan collaborated to create the “Setouchi Brand” to be used jointly as the common brand for tourism and food products for business promotion.

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