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Depositors' Bank Selection Behavior: Depositors Demand Slightly Higher Interest Rates from Banks Whose Financial Health Is Not Sound

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Up to now, supervisory authorities have kept a close watch on the financial conditions of banks. Some attribute this to the fact that the monitoring of banks by depositors and shareholders has failed to function properly. However, is it really true that neither depositors nor shareholders have been interested in banks' financial conditions? This paper will focus primarily on the behavior of depositors to see whether they have exercised bank governance during the past 10 years of turmoil in the financial system

An Examination of Interest Rates on Large, Fixed-term Deposits Offered at Banks

It is assumed that principally three parties, namely, financial supervisory authorities; depositors (who are creditors) and shareholders enforce discipline on banks. According to Martinez Peria and Schmukler (2001), it is possible to confirm the existence of bank discipline by depositors when they demand higher interest rates than prevailing rates from a bank while at the same time withdrawing deposits from it.

First, this paper will examine whether there are differences in deposit rates offered by banks depending on the degree of soundness of banks' financial conditions. Here, interest rates on large, fixed-term deposits offered by 20 major city banks and regional banks (commercial banks) will be used as the gauge. Meanwhile, the following indicators of the soundness of banks' financial health will be used: 1) The capital adequacy ratio of the Bank for International Settlements, which is an indicator of the quality of a bank's own capital; 2) The ratio of loans to the real estate sector to the bank's total lending. Because the bulk of non-performing loans (when Japan was beset with the problem of bad loans) were loans relating to real estate, it is assumed that this ratio represents the quality of a bank's assets; 3) Return on assets (ROA), which is the ratio of net operating profits to total assets; and 4) The ratio of cash and deposits to total assets. The cash ratio has been selected to see how much liquidity the bank has on hand to meet sudden depositor demand for withdrawal of funds.

Table 1 shows the relationship between interest rates on large, fixed-term deposits and the indicators of the soundness of banks' financial conditions based on semiannual data for the period from fiscal 1992 (ending in March 1993) to fiscal 2003 (ending in March 2004). The variables indicating the soundness of banks are all significant and, with the exception of the cash ratio, showed expected signs. This is to say that the less sound the banks' financial conditions (i.e., the lower the BIS capital adequacy ratio and ROA and the higher the ratio of real estate-related loans), the higher was their interest rate on large, fixed-term deposits. Similar results were obtained with respect to large, fixed-term deposits of one month, three months, one year and two years.

Table 1 : The Less Sound the Bank, the Higher the Deposit Rate

	Coefficient	Z-value	
BIS capital adequacy ratio	-0.04	-2.06	**
Real estate-related loan ratio	0.01	1.84	*
ROA	-0.27	-3.96	***
Cash ratio	0.11	18.30	***
Bank assets outstanding	-0.11		***
Long-term credit bank dummy	0.37	2.72	***
Trust bank dummy	-0.14	-2.64	***
Constant term	1.90	4.37	***

Notes: 1. The dependant variable is interest rates on large, fixed-term deposits of 6 months.

2. Results were obtained by a panel Generalized Least Square (GLS) estimation, in which heteroscedasticity of individual banks is controlled.
3. Deposit rates are average rates for the six months (weekly data) from the day after the release of banks' financial data to the date of the release of the following account settlements.
4. Except for the dummy variables, the values are for the preceding term (six-month period).
5. * Significant at the 10-percent level, ** significant at the 5-percent level; and *** significant at the one-percent level.

Bank Switching Depends on a Bank's Financial Conditions and Size

However, the above findings fail to distinguish cases in which banks with inadequate capital offer, as a last resort, high deposit rates in order to acquire deposits, from those in which depositors demand rather high deposit rates from unsound banks. To solve this problem, this paper will simultaneously examine deposit rates and the rates of increase in deposits.

It is not possible to obtain the outstanding balances of large, fixed-term deposits from the financial data of individual banks. However, a separate study conducted by this writer [Konishi and Fueda (2004)] confirmed that the greater the extent of unsoundness of a bank's financial conditions, the greater is the extent of deposit withdrawals. In that study,

1) the relationship between the outstanding balance of deposits immediately before the partial lifting of deposit protection (in April 2002) (in terms of the rate of change from the previous fiscal year) and the indicators of a bank's financial soundness and 2) the relationship between deposit rates and the indicators of a bank's soundness were examined for deposit-taking financial institutions, including all banks, shinkin banks, and credit associations¹.

Based on the findings of this earlier study and the analysis in this paper, it can be assumed that depositors are enforcing discipline on banks by withdrawing deposits from unsound banks and also by demanding rather high deposit rates from them. At the same time, depositors could be selecting banks by trusting the government's policy of "too big to fail" for financial institutions. With respect to the latter, results of an analysis which includes the size (the outstanding balance of total assets) of banks confirmed that the larger the bank, the higher was the rate of increase in fixed-term deposits and the lower were deposit rates.

U.S. "CAMELS" Also Includes Soundness Indicators

These indicators of the soundness of banks' financial conditions are also included in "CAMELS," the U.S. bank rating system (Table 2). In Japan, a similar rating system is said to have been used by the Banking Inspection Department (1981-1998) of the then Ministry of Finance². With the exception of M (management) and S (sensitivity to market risk), the components of "CAMELS" can be obtained with relative ease from financial data released by financial institutions. Japanese depositors evaluate banks on the basis of these criteria, which are being adopted by the financial supervisory authorities, and select banks by withdrawing their deposits or demanding rather high deposit rates. With the complete lifting of the ban on payoff, all deposits, except those for account settlements, are now unprotected. Therefore, it is assumed that depositors are now selecting banks more rigorously than ever before.

Table 2 : Bank Inspection Rating System in the U.S.

C	Capital adequacy
A	Asset quality
M	Management
E	Earnings
L	Liquidity
S	Sensitivity to market risk

¹ Due to the partial lifting of deposit protection, the protection of fixed-term deposits in case of a bank failure was capped at 10 million yen in principal plus its interest. Immediately before this change, there was a massive shift of funds from fixed-term deposits to liquid deposits.

² *Nikkei Kinyu Shimbun* dated February 17, 2005, p.3.

In July 2006, Financial Inspection Rating System (FIRST), which may be regarded as a report card for banks, was inaugurated in earnest. Under this system, the Financial Services Agency evaluates banks into four ranks with respect to nine items, including the “compliance-system” and “credit risk management system,” and uses their results to determine the frequency and scope of subsequent bank inspections. However, the results of the evaluation are conveyed only to the bank in question and are not disclosed to the public. This being so, the questions of how depositors will evaluate banks’ systems for risk management and credit risk management, and how they will integrate their evaluations into their bank selection behavior in the future, are themes this writer wishes to study further.

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