The Effects of Regulation on Interest Rates for Bank Lending: The Case of Compensating Balance Requirements in Japan

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Abstract

Financial institutions, especially banks, tend to be subject to regulations and such regulations affect the behavior of financial institutions. Compensating balance requirements—banks requiring borrowers to keep certain amount of deposit balances in exchange for loans—during the high-growth era of Japan is one of such examples. Compensating balance requirements (*kosoku yokin* in Japanese) by banks in Japan were often criticised and sometimes even became a political issue, while not so much empirical studies for the actual effects of compensating balances are conducted partly due to the lack of data. In this paper, we review the history of regulations on interest rates and compensating balance practises and then examine what types of borrowers tended to be imposed compensating balances, relying on newly collected firm-level data sets for relatively large firms.

The results of empirical tests show that compensating balances functioned as the adjustment tool for the caps on lending rate; highly indebted firms tended to be imposed larger amount of compensating balances against their debt outstanding, while growing firms could enjoy lower compensating balances. At the same time, relatively profitable firms were imposed higher effective lending rates. This phenomenon could be interpreted that banks lend firms with profitable project in spite of credit risks with higher effective rates on loans. In addition, the result shows that the macroeconomic uncertainty pushed up the compensating balances against debt outstanding of borrowers, while uncertainty of each firm and industries diverged from macroeconomic conditions were not influential.

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