Supplementary Explanation for the Outline of "Special Deposit Facility to Enhance the Resilience of the Regional Financial System"

1. Purpose and overview of the facility

The Bank of Japan decided on a plan to introduce a new deposit facility (hereinafter referred to as "the Special Deposit Facility") as a measure to ensure financial system stability, in which excess reserve balances* of eligible financial institutions that meet certain requirements shall be remunerated (hereinafter referred to as "special remuneration") in addition to the remuneration in the Complementary Deposit Facility. This decision aims to strengthen the business foundations of regional financial institutions so that they may firmly support regional economies into the future and smoothly fulfill their financial intermediation function.

The Special Deposit Facility shall be introduced as a three-year temporary measure for the fiscal years ending March 2021-2023, within which the requirements shall be met, with the aim of encouraging regional financial institutions to accelerate their efforts to strengthen business foundations.

* Current account balances held at the Bank in excess of required reserves. The same shall apply hereinafter.

2. Eligible financial institutions

Regional banks and shinkin banks that have current accounts at the Bank and wish to use the Special Deposit Facility.

After consultations with relevant parties, such as the central organizations of financial cooperatives (the Shinkin Central Bank, the Shinkumi Federation Bank, the Rokinren Bank, and the Norinchukin Bank), the Bank shall decide whether to allow financial cooperatives that do not have current accounts at the Bank to use this facility.

3. Requirements for special remuneration

In the Special Deposit Facility, special remuneration shall be paid, provided that eligible financial institutions shall meet all of the following requirements in (1)-(3).
(1) Being committed to contributing to sustainable development of regional economies

Each eligible financial institution shall express its commitment to contribute to sustainable development of regional economies.

(2) To meet any of the following:

(i) To strengthen business foundations to a designated degree

(a) For each of the fiscal years ending March 2021-2023, each eligible financial institution's overhead ratio (OHR, or the ratio of overhead costs to gross operating profits)** shall improve by a percentage equal to or greater than a certain threshold compared to the OHR for the fiscal year ending March 2020.

Those wishing their excess reserve balances to be remunerated by meeting this requirement shall submit "Initiatives to Strengthen Business Foundations" to the Bank in advance and periodically report the progress to the Bank. The Bank shall continuously monitor this progress.

The Bank will set the appropriate levels of thresholds for OHR changes in line with the preliminary figures in the table below. The specific figures will be decided later based on the results of deliberations.

<table>
<thead>
<tr>
<th>OHR changes to be satisfied</th>
<th>Fiscal year ending:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>March 2021</td>
</tr>
<tr>
<td>-1% or lower</td>
<td>-3% or lower</td>
</tr>
</tbody>
</table>

** The OHR shall be calculated as follows (on a consolidated basis). For regional banks belonging to a holding company that primarily owns regional banks, the OHR shall be calculated for the said holding company on a consolidated basis. The Bank shall make a single judgement as to whether said regional banks meet the requirement for the OHR on that basis (the same shall apply to the requirement for overhead costs prescribed in (b)). Changes in the OHR shall be calculated as the OHR for each of the fiscal years ending March 2021, 2022, and 2023 divided by the OHR for the fiscal year ending March 2020 (the same shall apply to changes in overhead costs prescribed in (b)).

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\text{OHR} = \frac{\text{Overhead costs (excluding depreciation expenses)}}{\text{Gross operating profits (excluding realized gains/losses on bondholdings, gains/losses from investment trusts due to cancellations, and interest income paid in the Special Deposit Facility)}}
\]
(b) For those that do not meet the requirement for the OHR prescribed in (a), business foundations shall be deemed to have been strengthened to a designated degree if, for each of the fiscal years ending March 2021-2023, each eligible financial institution's overhead costs (excluding depreciation expenses) shall decrease by a percentage equal to or greater than a certain threshold compared to the overhead costs for the fiscal year ending March 2020.

The Bank will set the appropriate levels of thresholds for overhead cost changes in line with the preliminary figures in the table below. The specific figures will be decided later based on the results of deliberations.

<table>
<thead>
<tr>
<th>Fiscal year ending:</th>
<th>March 2021</th>
<th>March 2022</th>
<th>March 2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overhead cost changes to be satisfied</td>
<td>-2% or lower</td>
<td>-4% or lower</td>
<td>-6% or lower</td>
</tr>
</tbody>
</table>

**Rationale behind the Chosen Benchmarks and Their Thresholds**

- As the benchmark to measure the degree of strengthening business foundations, the Bank shall use the OHR and evaluate its improvements. The OHR can be applied regardless of regional financial institutions' business scope and balance sheet size and can evaluate these institutions' efforts both in terms of revenue increase and cost reduction.

  In this context, realized gains/losses on bondholdings, gains/losses from investment trusts due to cancellations, and interest income paid in the Special Deposit Facility shall be excluded from gross operating profits so that only sustainable income is identified. Also, depreciation expenses shall be excluded from overhead costs so that regional financial institutions' investments aimed at strengthening their revenue bases shall not be discouraged and that temporary fluctuations of the costs associated with such investments shall be removed.

- The threshold for OHR changes (a reduction of 4 percent in three years) is based on the figures achieved by approximately 10 percent of regional financial institutions in recent years. If regional financial institutions as a whole manage to strengthen their business foundations at this pace, the sustainability of Japan's regional financial institutions into the future will be sufficiently enhanced.

- However, due to the spread of COVID-19, uncertainty about future economic and financial conditions is quite high. On this basis, the requirement for the overhead costs prescribed in 3.(2)(i)(b) is also introduced, in order to
incentivize eligible financial institutions to strengthen business foundations when they face huge downward pressure on gross operating profits in the future, due to economic stagnation. In particular, business foundations shall be deemed to have been strengthened to a designated degree if eligible financial institutions reduce overhead costs by a percentage equal to or greater than a certain threshold, which can be achieved through their self-reliant efforts. The threshold for overhead cost changes shall be set based on the figures achieved by approximately 10 percent of regional financial institutions in recent years, which is similar to that for OHR changes.

(ii) To make an institutional decision on mergers, business integration, or certain forms of acquisitions toward strengthening business foundations

To meet the requirements for special remuneration, eligible financial institutions shall make institutional decisions on mergers, business integration, or certain forms of acquisitions between November 10, 2020 and the end of March 2023. The Bank shall judge, based on such materials as business integration plans, if such mergers, business integration, or certain forms of acquisitions shall contribute to strengthening business foundations.

Those wishing their excess reserve balances to be remunerated by meeting this requirement shall submit such materials as business integration plans to the Bank in advance and periodically report the progress to the Bank. The Bank shall continuously monitor this progress.

(3) There being no special circumstances in which such remunerations are deemed inappropriate

4. Methods for special remuneration

(1) In the Special Deposit Facility, excess reserve balances shall be remunerated. The Bank shall set for each eligible financial institution a limit to the amount of excess reserve balances subject to special remuneration, with the aim of ensuring appropriate operation of the Special Deposit Facility and conducting money market operations smoothly.

- Such limit shall be the higher one of the following.

   (i) The amount calculated by multiplying each eligible financial institution's excess reserve balance outstanding in the past by the rate of change in the overall excess reserve balances outstanding held by all the account holders at the Bank.
(ii) The sum of each eligible financial institution's basic balance and macro add-on balance.

(2) In the Special Deposit Facility, excess reserve balances shall be remunerated according to the reserve maintenance period under the reserve deposit requirement system.

- For eligible financial institutions that meet the requirements prescribed in 3 (2)(i) in each of the fiscal years ending March 2021-2023, their excess reserve balances shall be remunerated for one year, starting from the September reserve maintenance period in the next fiscal year. If eligible financial institutions that do not meet the requirements for the fiscal year(s) ending March 2021 and/or 2022 meet the requirements for the subsequent fiscal year(s) (the fiscal year ending March 2023 at the latest), the Bank shall pay in the subsequent fiscal year(s) the amount equivalent to special remunerations for the past fiscal year(s).

- For eligible financial institutions that meet the requirements prescribed in 3 (2)(ii), their excess reserve balances shall be remunerated for three years, starting from the next reserve maintenance period after the Bank's evaluations and necessary preparations complete.¹ Such evaluations shall be conducted, following institutional decisions on mergers, business integration, or certain forms of acquisitions, as to whether the decided case shall contribute to strengthening business foundations, based on such materials as business integration plans. However, if such mergers, business integration, or certain forms of acquisitions fail to materialize, eligible financial institutions shall return the amount equivalent to special remunerations to the Bank.

(3) When a regional bank integrates its business with a holding company that primarily owns regional banks, special remuneration shall be paid to excess reserve balances held by all of the respective regional banks belonging to the said holding company. When a regional bank integrates its business with a bank other than a regional bank, a banking group mainly consisting of banks other than regional banks, or non-financial companies, only an excess reserve balance held by the said regional bank shall be remunerated. For other forms of mergers, business integration, and certain forms of acquisitions, the Bank will judge the scope of special remuneration in each case based on the purpose of the Special Deposit Facility prescribed in 1. above.

¹ In the earliest case, special remuneration will likely be applied from April 16, 2021.
5. Interest rate

The interest rate applied to excess reserve balances in the Special Deposit Facility shall be +0.1 percent per annum.2

6. Exception

If the Bank deems it necessary to ensure appropriate operation of the Special Deposit Facility and to conduct money market operations smoothly, it can make exceptions to the prescribed.

7. Disclosure

The Bank will make public the names of eligible financial institutions that receive special remunerations once a year, in principle.

8. Next steps

The Bank will deliberate on the facility in a prompt manner, taking into account opinions of relevant parties. The principal terms and conditions for its implementation will be decided at a future Policy Board meeting.3

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2 For eligible financial institutions that meet the requirements prescribed in 3, their excess reserve balances shall be remunerated at +0.1 percent per annum (from the fiscal year ending March 2022 at the earliest in accordance with the description in 4), in addition to the remuneration in the Complementary Deposit Facility (currently +0.1 percent per annum for the basic balance, +0.0 percent per annum for the macro add-on balance, and -0.1 percent per annum for the policy-rate balance). The application of the positive interest rate of +0.1 percent per annum under "Special Funds-Supplying Operations to Facilitate Financing in Response to the Novel Coronavirus (COVID-19)" will not be affected.

3 The Bank will also deliberate on matters associated with government approval that are necessary to implement the facility.