



INTEREST SPREAD AND THE ECONOMIC IMPACT

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INTRODUCTION

Undoubtedly, the banking sector plays a pivotal role in the economy, essentially functioning as the market intermediary and the creator of credit. The core banking activity has been to mobilize deposits by paying interest and lending such funds and earn interest. With the liberalization of the interest rates, the banks are given the full autonomy to decide on their deposit and lending rates (interest spread).

Just a snap look reveals that the average saving rate being around 7% and the short term lending rate around 19%, the banks being the market intermediary enjoys a clean margin of 12%. This seems a little high considering the real return of the depositors in an inflationary market scenario. Comparative statistics suggest that the spreads applied by the newly industrialized countries is even less than 2%.

Interest Spreads and Margin

The prevalent practice among banks is to maintain a wide interest margin in order to compensate for cost inefficiencies and to report high profits. As such, banks tended to change lending rates and deposit rates in such a manner that ensures a minimal impact on the interest spread, thus enabling them to achieve higher profits. As a consequence, the interest spread displayed only a marginal decrease (Chart 3.17)

A tendency to maintain a high interest spread is evident, although the interest spread band of the LCBs had narrowed by September 2006 (Chart 3.17). Despite displaying a reducing trend over the last two years, the interest spread of the Sri Lankan banking sector is still considered to be high, at 3.7% by regional standards.

(Financial System Stability Review 2006, Central Bank of Sri Lanka pg 33)



The writer attempts to identify the possible reasons for the thicker margins solicited by the banking sector in Sri Lanka and to analyze the possible impact on the economy by the application of the above.

It was not an easy task to find the relevant reliable statistics nevertheless the statistical information does not reflect the real situation as it tend to average results and includes approximations. However, statistics have been used wherever possible to support the views expressed, based on the available minimum information. The views expressed in this article are purely the writer's personal observations.

SPREAD ATRIBUTES

The commercial banks, essentially being market intermediaries, enjoy healthy margins which have been clearly reflected in their financial results for the last few years. Commercial banks have shown a steady growth in their profitability, with a tremendous growth in their respective balance sheets.

A closer look at the profitability of the commercial banks for the year ended 31st December 2006 suggest that, quite a number of banks have exceeded the LKR 1 billion mark in their profits. Probably identifying the growth potential of the sector, under budgetary measures too, various sector specific taxes have been imposed by the government which effectively in toto, well exceeds 60%.

Interest spread, the difference between what a bank earns on its assets and what it pays on its liabilities, of the banking industry has been on the rise for the last few years. A closer look at the available statistics suggest that, the banks have been spreading their margins steadily throughout, indicating probably the stability of the financial sector.

The **Table 1** below indicate the spread between the Average Weighted Deposit Rate (AWDR) and the Weighted Average Prime Lending Rate (WAPLR) from 2004 to 2007 (1st Qtr) which clearly indicate a rising trend. The average spread of 4.86% in 2004 has risen to 11.75% in 2007 (up to 1st Qtr), more than 140% increase.



Table 1
Average Interest Spread

Period	Average Weighted Deposit Rate AWDR	Weighted Average Prime Lending Rate WAPLR	Average Interest Rate Spread
2004	5.31	10.17	4.86
2005	6.24	12.14	5.90
2006	7.60	15.19	7.59
2007*	8.26	20.01	11.75

** Upto March 2007*

Source: Central Bank of Sri Lanka - Bulletin - April 2007

On average, interest bearing deposit rates vary from 5% to 15% p.a., where as average lending rates vary from 13% to 30% p.a in times, even more. The Weighted Average Prime Lending Rate (WAPLR) displayed above is the average lending rate of the banks to its prime (best) customers, in reality, few in number. It suggests that in reality, the banks enjoy even higher margins.

The probable reasons for the thicker margins could be attributable to,

- i) Interest Insensitivity of Deposits
- ii) Lucid Behavior of Depositors
- iii) Market Structure of the Industry
- iv) Average Size of the Transaction,
- v) Pressure for Profitability
- vi) Quality of Lending
- vii) Opportunity Cost of Holding Mandatory Reserves
- viii) Impact of Tax
- ix) Economic and Market Conditions
- x) Probably the Inefficiency in the Processes.

i) Interest Insensitivity of Deposits

A closer look at the industry statistics reveals that domestic savings have remained almost unchanged despite the increase in the interest rate spreads by the banks. Interest spreads of the banks have increased to 11.75% in 2007 from 4.86% in 2004. However it seems to have not impacted the domestic savings which suggest that the domestic savings are interest insensitive or interest rate inelastic.



The interest inelasticity of deposit supply to the banks or the interest insensitivity of deposits (bulk of the core deposits) would have been a possible contributing factor for the higher spreads of interests. Theoretically, changes in the T-bill rate are passed on to the deposit and lending rates of the banks. Greater the inelasticity of deposits, the less compelled a bank would be to pass on the increase in T-bill rate to the deposits.

At the time of writing this article (August 2007) the average 3 months treasury bill rate is around 17.25% whereas the three months average deposit rate is around 14%, if the deposits were interest elastic, theoretically the banks would have to pay an interest rate above the T-bill rate to compensate the extra risk the depositor is willing to accept.

It could be argued that the high level of inelastic deposit supply leaves little incentive to the bankers to adopt competitive rates there by not impacting the spreads. It is felt that the emergence of alternate financial intermediaries is essential for lowering the spreads.

In reality, as explained in detail later, the depositors have been receiving negative real returns for the last few years though there has been a noticeable growth in the deposits.

ii) Lucid Behavior of Depositors

Greater the interest spread by the banks, lower the interest rates paid on the deposits. The interest sensitive depositors, mostly the high net worth depositors would read it as a disincentive to save. They would probably withdraw and invest in real assets creating a temporary drop in the bank savings.

However, the person who receives the money in return for the exchange of his assets, would immediately invest them back in the banking system even at lower interest rates, squaring off the position created earlier.

The ultimate end result is the deposits only changing hands, without any impact on the saving base of the banking system.

In a developing economy, the application of so called economic theory that the drop in deposit interest rates, discourage savings, thereby enhance investments, may not fully operational without the other market ingredients such as required infrastructure, incentives, minimum bureaucratic delays, tax concessions etc and the economic growth as a whole.

iii) Market Structure of the Industry

Almost 60% of the commercial banking deposits being well secured with the two state banks, they are at a higher leverage in manipulating the deposit rates. As stated above, the depositors freely attracted to the two state banks having the sovereign backing as merely safe deposits and not as investments. State banks while dominating the market therefore in an advantages position to suppress the deposit rates.

On the other hand, the non performing advances ratio as a percentage of the total advances



of the two state banks, on average is well over 10% which invariably results in higher costs, profitability and liquidity related issues. The cost income ratio of the two state banks well exceeds 70% which again results in increased cost of funds.

Even if there is pressure from the government and Central bank, the high cost of funds of the two state banks prevents them from reducing the margins. This would probably help the other banks to capitalize on the margins.

iv) Average Size of the Transactions

It could also be due to the comparative smaller average size of deposits that invariably lead to increased transaction cost. Banking sector in Sri Lanka, in general concentrate in retail banking operations, where, average size of a transaction is small. Sri Lanka being a developing country, though there is a comparatively higher domestic saving rate, major part of it is from the small timers. The disparity in income distribution too suggests that most of the savers save in smaller quantities increasing the volume of transactions leading to high maintenance cost to the banks.

v) Pressure for Profits

It is quite evidenced that the banking sector, specially the private sector is pressed for profits, if not, to enhance shareholder wealth. With the prevailing economic and interest conditions, shareholders expect a comparatively high rate of return on their investments. The financial sector, especially the banking sector has managed to keep upto the expectation of their stake holders.

The average T-bill rate being around 17%, the inflation well exceeding 18%, the shareholders expects a minimum return of at least 20% which the banks may be struggling to fulfill under inflationary economic conditions coupled with an environment not so conducive for investment.



17 August 2007 09:07:34 Lanka Business Online

Sri Lanka banking sector grew 9.5% in first half of 2007: CB

August 17, 2007 (LBO) – Sri Lanka’s banking sector assets had expanded 9.5 percent, with loans rising 11.2 percent against deposit growth of 7.6 percent, the Central Bank which regulates the sector said.

“Banking sector has shown a significant expansion during the first half of 2007 reflecting continued expansion in economic activity,”.

Performance

Assets had grown by 203 billion rupees. Loans grew by 144 billion rupees outpacing total deposits, which grew by 114 billion.

Banks had earned a pre-tax profit of 26 billion rupees, up 23 from 21 billion last year.

“This profit growth has led to increase the return on assets from 2.2 percent to 2.3 percent,” Central Bank said

Number of banks have well exceeded the LKR 1billion mark giving positive signals to the shareholders to demand more. Shareholders, in general, expect positive growth over previous performance and hence the bankers are compelled to keep up to that expectation.

Such pressure for enhanced profits may too have probably contributed to the fatter margins that the banks currently set.

vi) Quality of Lending

The stringent rules on non performing loans (NPL) has a direct impact on the profitability of the banks, both from the provision and write-offs and suspension of interest. In addition to the long practiced specific provision the introduction of the general provision too has burdened the bankers though prudent in application.

Non performing advances while curtailing the credit creating ability of the commercial banks push the banks towards liquidity and cash flow related issue. A loan that was expected to be settled in 2-3 years would not bring in the expected liquidity if the loan becomes NPL leading to liquidity gaps.

The impaired advances portfolio due to NPL, increase the asset risk weight thereby adversely affecting the adequacy of capital.



The bankers are therefore, probably compelled to recover that additional burden on the financials through the enhancement of the interest spread. The end result being the creditworthy borrowers indirectly paying for the defaults of a few.

17 August 2007 09:07:34 Lanka Business Online

Asset Quality

Non-performing loan ratio was around 5.7 percent, with high loan growth. Credit card advances had grown three billion rupees (10 percent) and non-performing loans were around 6 percent. Capital funds had increased by 21 billion (13 percent) giving a better cushion for risks, the Central Bank said.

Prudential Measures

The Central Bank had also implemented prudential measures to reduce risks by imposing a one percent general provision of performing advances to be charged at 0.1 percent per quarter over ten quarters starting in December 2006.

Authorities had increased capital levels by raising risk weights relating to some banking assets. Authorities had increased the risk weights applicable to some banking assets requiring the banks to maintain a higher level of capital and advised banks to curtail lending for consumption.

The Central Bank was also periodically monitoring bank credit delivery at targeted levels in line with monetary policy framework, maximum lending limits of banks to reduce credit concentration risk

vii) Opportunity Cost of Holding Mandatory Reserves

As per the CBSL regulations, 10% of the deposits that have been mobilized as deposits have to be kept with the central bank as Statutory Reserve Requirement (SRR). This balance as per the **Table 2** below is a significant amount for the banking system amounting to LKR 82.2 billion as at end March 2007.

Banks while incurring an interest cost on one hand against the above balance, lose the opportunity of lending them in the market on the other hand resulting in a significant income loss. One can argue that to compensate the lost interest, banks are compelled to keep a reasonably thicker margin of interest.



Table 2
Reserve Position of Commercial Banks
Rs. Millions

Period	Required Reserve (SRR)	Cumulative (SRR)
2004	55,965	391,754
2005	67,328	471,296
2006	79,081	553,569
2007	82,268	575,878

Source: Central Bank of Sri Lanka Bulletin April 07

viii) Impact of Tax

Despite the contribution that the banks make towards the economy, successive governments have used the banks as a means of bridging the fiscal policy gaps through subjecting to excessive taxes.

Banks at present are subjected to Income tax, Value added tax, Withholding tax, Debit tax, Financial Services VAT which in total well exceeds 60%. In addition banks are subjected to stamp duty which too is a main source of government revenue.

The excessive taxes may possibly compel the banks to keep fatter margins.

ix) Economic and Market Conditions

The prevailing economic conditions with high inflation and interest rates have probably compelled the banks to enhance the spreads to keep in line with the demanding pressure from the investors. When the market interest rates are on the rise, expected return of the shareholders too would be relatively high. Both shareholders and long term lenders therefore expects a higher return for their investments

Similarly, in an unsettled economy with political instability, investors generally adopt a “wait and see” attitude, hence, would not part with their funds if not for higher returns to adequately compensate.

Under inflationary conditions, the risk of default by the borrowers to the bank would be on the rise specially the credit card related transactions.

Therefore, the banks would be consciously setting their interest spreads to compensate the possible loss.



x) **System Inefficiencies**

Except for few, most of the banks' cost/income ratios are well over 60% which is comparatively a high proposition. The cost income ratio of two state banks well exceeds 70%. The heavy cost of process duplications, inefficiencies, delays in decision making etc, have contributed towards the swollen operating cost.

Sri Lanka, as a country seems to have the highest number of holidays or non working days which would probably a highest contributor for the rising operating cost. On average during 2007, more than 125 days, (35%) of the time, the banks are closed, during which period the interest accruals and salary accruals continue to work.

A detailed analysis of some of which could probably help reduce the cost tremendously. It is felt that, banks in general, without having a critical look internally, have conveniently passed the burden to the depositors and borrowers through the adjustment of the spread.

COMPARATIVE STATISTICS

Average Interest Spread – Regional Comparison

An attempt to compare the sector statistics with a cross section of the region suggests that we have been maintaining the highest spreads throughout the past few years. The **Table 3** below for selected countries in the South East Asian region for 2006 suggest that countries like Korea and Taiwan being the leading industrial countries in this region, had managed to maintain the interest spreads below a bear minimum of 2%.

Myanmar being an exception giving the highest deposit and lending rates in the region still managed to maintain an average interest spread of 5%. Singapore and Malaysia being leading economies operates with a spread of 4.4% and 2.98% respectively.

The comparative figures for other regions too suggest similar proposition which I feel therefore needs a closer scrutiny.



Table 3
Average Deposit and Lending Rates for 2006

	Deposit Rate	Lending Rate	Interest Spread
Korea	4.47	5.89	1.42
Taiwan	2.06	3.95	1.89
Thailand	4.75	7.50	2.75
Malaysia	3.74	6.72	2.98
Philippines	6.32	9.92	3.60
Singapore	0.89	5.30	4.41
Myanmar	12.00	17.00	5.00
Nepal	2.25	8.00	5.75
Sri Lanka	7.60	15.19	7.59

Source: Central Banks, CEIC and IMF International Financial Statistics, 2006

THEORETICAL PERSPECTIVE

Negative Real Return

$$\text{Real Return} = \text{Nominal Return} - \text{Inflation}$$

$$\text{Negative Return (10.34\%)} = \text{AWDR 8.26\%} - \text{18.6\%}$$

Theoretically, the real return from an investment is the nominal return less the inflation rate. The application of the above principle to the depositors indicates a negative real return. The attribution of AWDR and the current inflation rate of 18.6 (As of March 2007 CBSL bulletin) to the above formulae suggest that the depositors receive a negative real return of 10.34%.

A simple explanation suggest, at a static inflation rate of 18% and an AWDR of 8.26% that, a Rs.1000 worth of a good would be Rs.1,186 at the end of one year from now, where as a Rs.1000 deposit would grow upto Rs.1082.60 thereby incurring a loss of Rs 103.40.

The **Table 4** below suggests that the average real return of investors for the last four years have been negative. The negative real return has been on the increase over the years. However, it is interesting to note that the total deposits have been on the increase (Refer Table **Table 2**).

It is a clear endorsement of the fact that most of the deposits are interest inelastic.



Table 4
Average Real Rates

Period	(AWDR) Average Nominal Rate	Average Inflation Rate	Average Real Rate
2004	5.31	8.67	(3.36)
2005	6.24	10.85	(4.61)
2006	7.60	16.25	(8.65)
2007	8.26	17.56	(9.30)

Source: Central Bank of Sri Lanka Bulletin April 2007

Source: Central Banks, CEIC and IMF International Financial Statistics, 2007

At this juncture, one could raise the obvious and sensible question “so why do they save?” which I believe is related to the cultural and social upbringing of the depositors. In fact, the current T-bill rate (17.25%) is attractive than the bank deposit rate, still why aren't they invest in T-bills. May be the lack of awareness or ignorance at which expense the banks are benefiting.

The comparative position in the **Table 5** below suggest that Myanmar, Korea and Thailand indicates positive real returns to investors where Sri Lanka leads the list with highest negative return. If not it suggest that something is fundamentally wrong in the interest structure of the banking sector in Sri Lanka.

Table 5
Average Real Return

	Deposit Rate	Inflation Rate	Real Return
Myanmar	12.00	9.30	2.70
Korea	4.47	2.60	1.87
Taiwan	2.06	1.70	0.36
Malaysia	3.74	3.90	(0.16)
Singapore	0.89	1.10	(0.21)
Philippines	6.32	6.70	(0.38)
Thailand	4.75	5.60	(0.85)
Nepal	2.25	7.90	(5.65)
Sri Lanka	7.60	17.70	(10.10)

Source: Central Banks, CEIC and IMF International Financial Statistics, 2006



Risk Return Disparity

In portfolio theory, Capital Asset Pricing Model (CAPM) suggests that risk and return are positively related. The investors expect extra premiums of return for the additional risk that they are willing to take.

In a rising interest rate scenario, the government offering a higher rate, with theoretically zero risk would probably push the risk free return of an investor up. With the increased market volatility, the average market return too would be on the rise where the impact from the market beta would further put upward pressure resulting in higher expected return from similar investments.

$$R_e = R_f + \beta(R_m - R_f) \longrightarrow \text{CAPM}$$

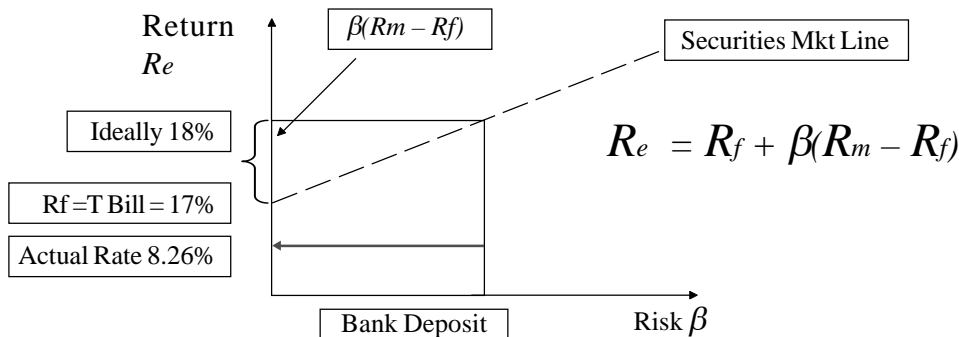
Where R_e is the Expected return or the cost of equity, R_f is the risk free rate of return, R_m is the expected return on the market portfolio, and β is the measure of the responsiveness of the portfolio to the market risk.

The $\beta(R_m - R_f)$ of the above formulae is the additional premium that an investor expects for the additional risk that he undertake.

The risk free return R_f could be attributable to the average T bill rate (17%) as fully backed by government. However, the investment in bank deposit theoretically is more riskier than the sovereignty of the state hence the depositor should be paid an additional premium $\beta(R_m - R_f)$ for the additional risk.

As shown below in the diagram, the risk free return being at 17%, and the bank deposits carry additional risk for which the depositors should be ideally paid an extra premium, say 18%.

However, it is evident from the past statistics that the depositors on average are only paid 8.26% creating a disparity in the interest rate structure, which cannot be explained through fundamental risk return theories.





POSSIBLE IMPACT ON THE ECONOMY

The increase in the interest spread discourages savings and deposits on one hand, and discourages borrowing on the other hand. Either way, it affects the economy adversely.

Excess Units (Depositors)

To keep the spreads thicker, the banks would offer lower interest on deposits discouraging saving and encouraging consumption probably leading to 'demand- pull' inflation. As argued earlier, the impact is not much visible as most of the small time depositors are non interest sensitive. The resultant impact is the discouraged saving (not getting the anticipated growth), as evidenced in **Table 2**.

The savers are now either compelled to spend them on consumption leading to demand pull inflationary impact on the economy, or look for other avenues that would give them an extra premium creating an informal market. Both propositions lead to adverse impact on the economy.

Deficit Units (Borrowers)

On the other hand the banks would push up the lending rates increasing the borrowing cost of the producers probably leading to cost push inflation.

Relatively high borrowing costs would discourage business investment there by suspending or postponing the possible economic trigger activity where the operation of the economic chain, come to an end.

Generally, when the business investment enhance in an economy, increased production and cost effective operation would have a downward pressure on the inflation while activating a chain reaction in the economy. Enhanced production makes way for job opportunities and speedier circulation of money resulting in economic growth.

Disintermediation

The traditional role played by commercial banks in an economy has been essentially, to act as the market intermediary. The commercial banks have been the linking pin of deficit and excess units in the market. Todate, the core banking activity of commercial banks is the mobilizing of deposits and lending them in the market though they provide other services over and over the core activity.

However, it is noted that the bankers are now facing a dilemma of attracting both depositors and borrowers to the banking sector as they (depositors & borrowers) have now taken a different route. Those depositors who are interest sensitive would look for higher interest and route their funds to other non banking institutions both regulated and non regulated.



The banks now seems desperately offering various benefits such as draws with houses and vehicles on offer, travel packages, insurance etc without critically looking at the process fundamentals and adjusting the spreads. The cost of such offers ideally should have been added to the interest cost but may not be rationale as the benefits are offered only to a few selected depositors.

Creating an Informal Market

The most damaging is the informal market created, the money lenders, where the collections and their incomes are unaccounted. The risk being, the market is not regulated, not subjected to taxes etc and the secondary economy created beneath. The traditional regulatory tools available to CBSL such as credit sealing, “moral suasion” etc would have little or no impact as far as these markets are in existence.

There seems to have no statistics of existence of such a market all of us are aware of. In the absence of statistics, the writer is unable to comment on the deposit base of the informal market participants, but it is the gut feeling that a considerable percentage is well secured by the informal players in both in deposit taking and lending.

The informal lending market is hassle free, less documentation (not at all) and prompt. Though the interest is little high the needy borrower serves his purpose with no time. It was also evidenced that the recovery process too of the informal lenders are very prompt as the consequences of non payment probably would be invaluable.

Interest Rates

With the deregulation of the financial market in Sri Lanka, the financials sector, specially, the individual banks are given the autonomy to decide on their lending rates. Banks by widening the spreads have unnaturally set the lending rates at higher levels. The high lending rates in the market probably send a wrong signal to the economy. High borrowing costs may discourage investments, while creating inflationary pressure through heavy production costs. It leads to issues with unemployment and curtail development in the economy.



CONCLUSION

The available Statistics revealed that the spreads have been on the rise in the country and the comparative statistics suggested that ours was in the highest in the region. However one can reason out that the country is agricultural based and yet developing, hence spreads need to be comparatively wider. Of course, as explained above, there are few justifiable reasons for the higher margins solicited by the banking sector.

The economy that is not that conducive for investments with rising inflation rates coupled with unsettled state of the north and east would pressurize the banks for wider spreads. With the government borrowing at 17%, shareholders expects a minimum return of at least 20% which seems not practical if not for widening the interest spreads. Advances to Deposit ratio of the banks possess a sizeable issue for the banks where some of the banks have exceeded their respective cap with excess advances, obviously funded through market borrowings at higher cost.

The possible negative impact on the economy through the wrong signals that it sends to the market is sensitive, if not uncalled-for of a sector vital for the proper conduct of the economy. Specially the process of disintermediation leading to creating a informal market is a sensitive issue which need immediate corrective action.

The writer strongly felt that it is time that as part of the corporate social responsibility, the bankers now get together, probably with representation from the regulator, closely review the interest structure and advocate corrective action for the betterment of the industry and the economy as a whole.



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