A More Constructive Path towards Setting Deposit and Lending Rates

With the deadline of implementing single digit interest rates looming on the horizon, understanding the potential ramifications of this directive has become imperative. While the intention behind the rate cut, that is to prop up the pace of industrialization and private investment, is no doubt important for the country to keep economic growth on track, the impact on the banking sector as well as unintended consequences should be carefully examined given the sensitivity of money flow to the entire economy.

While capping lending rates at 9% may mean that banks may engage in a more rigorous credit appraisal process before sanctioning loans to avert default, it may also mean that loan growth will be hampered. Unless alternatives are available, banks may disburse fewer small and medium enterprise (SME) loans and other high-risk entities as such loans involve comparatively higher monitoring costs and higher expected loss for banks. Hence, the intended economic stimulus by bringing down interest rates may not yield the desired results.

Lending rates need to be dynamic and risk adjusted. Entities that have a higher expected loss on a loan should be charged with a higher interest rate while those with high credibility can be charged 9% or even lower. Moreover, given that the associated costs for different loan categories vary, lending rates can also be capped based on the category of the loan. Hence, a way around this is to subject different loan categories to multiple caps instead of a single cap across the board. This model is already in use in South Africa where they have seven different rate caps while Vietnam has an exclusive cap imposed for priority areas such as SMEs, rural advancement and agricultural loans with a view to enhance growth.

Alternatively, a weighted average market rate can be used to arrive at the benchmark. There are a total of approximately 20 countries that follow this model. For instance, Colombia's interest rate ceiling is set 1.5 times above the average prevailing rate in the banking sector. The ceiling is fixed at a certain percentage above the average rate in the market for specific loan products in the European Union, such as 33% in France and as high as 100% in Germany.

It is also important to consider that lower deposit rates may exacerbate the cash crunch situation of the banks and instigate a bank run. We may have already witnessed a glimpse of the banking sector's possible future when recently as many as 5 million small savers rushed to the post office to liquidate their deposits after it was announced that the post office savings tool's interest rate will be slashed from 11.28% to 6% for 3-year deposits. Depositors may also fall prey to scammers who can exploit such a situation.

Deposit rates should instead be set based on the health of a bank, which is reflected in its capital adequacy and liquidity situation. Poorly capitalized cash crunch banks should offer higher deposit rates to compensate for the risks associated with depositing money in such banks. Rate consistency with that of other financial instruments also need to be maintained.

Additionally, factors such as service differentiation should also be allowed to play a role in interest rate determination as providing premium quality services come with their own costs.

Instead of micro-managing banks by setting a floor or ceiling for interest rates, the banking sector should be allowed to serve its purpose in facilitating a risk-based money flow in the economy so that money can find its own way into the hands of those who will put it to the most efficient use. Banks also need to be provided with the flexibility to fix their own interest rates that is constrained based on the associated risks and banks' own behavior, rather than being imposed with a single digit cap.

Since the ultimate objective is to bring down the cost of credit in the country, our focus should be on the root cause of the prevailing high interest rates - that is the piling non-performing loans (NPLs) in the banking sector, exorbitant government bank borrowing to finance the expanding fiscal deficit, high risk free rate, and excessive overhead costs in banks. Once these issues are addressed at a granular level, the high interest rate in the economy will organically come down to an acceptable risk adjusted level in due course of time.

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