IPP | **P**olicy **B**rief 16/2015

Convoluted Expectations from Banks

Shahid Kardar

Institute of Public Policy
Beaconhouse National University

All and sundry continue to protest about the lending behaviour of commercial banks and their large ‘spreads’ (the difference between the interest rates on their lending and the interest rate that they offer on deposits). That they are not catering adequately for the private sector, and SMEs in particular, and instead holding Rs.3.3 trillion worth of government securities, well in excess of the minimum Statutory Liquidity Reserve requirement established by the State Bank. Complaints abound that SBP rhetoric and moral suasion to get banks to lend to these neglected sectors is not enough and that it should “direct” them to advance funds to private enterprise, whereas the more sophisticated analysts argue that a robust system of incentives and disincentives be put in place to do get them to do this.

Faced with a large portfolio of non-performing loans of the private sector in an economy gasping for breath and a sovereign with a voracious demand for funds the banks are understandably reluctant to lend to the private sector in general and the SME and agriculture sectors in particular. Even the lowering of the interest rate on government securities by 2.5 percentage points in the last 12 months has not been that successful in luring banks away from government securities in favour of the private sector, although it has given respite to the private sector through the reduction in the servicing cost of its existing stock of debt.

Why are banks continuing to invest in government securities even after the attraction for such instruments is supposedly losing its luster with interest rates now below the expected rate of inflation and the prospects for capital gains on existing holdings in these securities having run out of steam? However, before we discuss this aspect we need to be mindful of two facts that are generally not well known or appreciated. To begin with, had the State Bank not ‘injected’ in excess of Rs.600 billion into the system, the deposit base of banks would not have been able to support the increased borrowing of both the government and the private sector, particularly at the current low rates of interest; without SBP pumping in money into the banking system the interest rate would have shot up to support this enlarged demand for funds from the existing pool of deposits. Secondly, the government has also borrowed close to Rs.420 billion for its “commodity operations” (its purchase of wheat, fertilizer and now sugar)- to appease different lobbies- at interest rates that are at least 1.5 percentage points higher than those charged by banks to their prime private sector borrowers! Therefore, banks are not just picking up more of government securities even at low interest rates they have other ways of making money at the expense of a reckless sovereign!

It is the State Bank's prudential regulations with respect to capital adequacy requirements for commercial banks that have tended to reinforce and strengthen this role of the banks. All commercial banks are required to maintain a "minimum capital to total risk-weighted assets ratio" of 8%, Resultantly, along with having to bear the cost of funds for holding government securities banks are also required to carry the burden of an additional charge on their activities, which in turn depends upon the categories of assets held in accordance with the "risk-weights" assigned to each. Presently, the risk weights assumed are zero for investments in government securities and 100% for practically all categories of loans including those to the most credit worthy corporations and businesses; and even the balances held with scheduled banks are assigned a risk-weightage of 20%. With this difference in relative capital costs owing to these risk weights the manner in which the capital adequacy norms are being applied has also created an incentive for banks to invest in government guaranteed securities. The large sums invested by the banks in government paper are largely then the natural outcome of these policies.

Even if these norms do get changed eventually it does not follow that when the commercial banks reduce their investment in government securities they will necessarily increase their private sector lending portfolio at the same pace. As other financial institutions pick up these securities there would be a flow of household savings to them, resulting in a shrinking in the deposit base of banks with, perhaps, only a marginal increase in the total value of loans made by them. Moreover, lower interest rates will also disincentivize household savings in rupee deposits even with reduced investment opportunities in the region-e.g. real estate in Dubai (although beginning to pick up, activity in this sector will take time to reach levels of the heady days).

Banks have to be given freedom in managing and pricing the asset side of their services that most commentators are reluctant to give, because banks are being expected to also serve social objectives through the asset side of the services, i.e., through loans and advances. Why should the principles that would not just be accepted, but stoutly defended, for organizations in other sectors, be different in the case of banks? In my view such objectives are better fulfilled through the liabilities side of the balance sheet, by serving and protecting the interests of the depositors. Compared with borrowers, depositors have lower per capita incomes. Therefore, if any social objectives are to be fulfilled, it is the interest of depositors that must be accorded a higher priority. It is not the banks but the government that has the responsibility to meet social objectives, a task in which it is failing by soaking up the bulk of household savings which it could put to better use, thereby discharging its social responsibilities more satisfactorily. The government for instance could amend the subsidized Export Refinance Scheme (72% of whose funds are with just 31 exporters-'big boys' who don't need official help) and restrict its scope to SMEs.

As for the issue of the large 'spreads' it will only get resolved once you take the Gorilla, Islamabad (with its insatiable appetite for funds to finance its misspending), out of the room. Following the government's diminished yearning for cash from banks the latter will have no choice but to compete among themselves when lending to the private sector, which will inevitably lead to a narrowing in these spreads. Regrettably, a substantial proportion of our private sector does not have the credibility required to raise funds, at any rate of interest, from the public, which is holding on to Rs.2 trillion worth of cash, the equivalent of 36% of bank rupee deposits.