Issues Relating to Interest Rate Spread in Commercial Banking System of Sri Lanka

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Introduction

An efficient and vibrant commercial banking and financial system are essential ingredients for any market economy to become successful. It is expected to provide lifeblood to the efficient and effective functioning of an economy. Commercial banks mobilize savings by offering various types of deposit products to savers and channel such savings as loans and advances to borrowers and investors. The difference between the rates at which banks lend money to borrowers and the rate they are paying to depositors are generally known as "interest rate spread" (IRS). The efficiency of the banking system is reflected by series of financial indicators and more importantly by IRS and Net Interest Margin (NIM). IRS is an important indicator of efficiency level of a bank or a banking system. It reflects profit maximizing ability of the financial intermediaries. The Central Bank of Sri Lanka repeatedly expresses its concern on IRS in the recent past. This is due to relatively higher IRS in Sri Lanka than other countries in the South Asian region. High IRS is causing high cost to borrowers and investors. On the other hand, it reduces the deposit income of the depositors.

Thus, the objective of the present study is to identify the factors that are contributing to high interest rate spread in Sri Lanka and identify actions needed to reduce the spread.

Literature Review

Over the past few years, interest rate spread of commercial banking system has caught researchers' attention throughout the world. As financial intermediaries, banks play a crucial role in the operation of most economies. The efficiency of financial intermediation can affect economic growth. Crucially, financial intermediation affects the net return to savings and the gross return to investment (Demirguc-Kunt, & Huizinga, 1999).

According to the prior researchers, IRS is described in several ways. IRS is a key variable in the financial system and when it is too large, it is generally regarded as a considerable impediment to the expansion and development of financial intermediation, as it discourages potential savers with low returns on deposits and limits financing for potential borrowers, thereby reducing feasible investment opportunities and therefore the growth potential of the economy (Barajas, Steiner, and Salazar ,1999). Robinson (2002) highlights that loan rates charged by commercial banks can be separated into two major components. One is the interest rate paid to depositors and the other rate is risk premium. That difference between the deposit rate and the loan rate is commonly referred to as the spread. IRS is defined as the difference between average interest rate earned on interest earning assets (loans) and average interest rate paid on deposits (Jayaraman and Sharma, 2003).

The magnitude of the spread will be depending on the determinants which determine it. Jayaraman and Sharma (2003) recognized the reasons for high IRS as lack of adequate competition, scale diseconomies due to small size of markets, high fixed and operating costs, high transportation costs of funds perceived market risks and the risk profile of the bankers.

Khawaja and Din (2007) examine to what extent macro economic variables influence the IRS. The central bank influences the yield on treasury bills of a country. That in turn affects the deposit and lending rates.

Methodology

The analysis of the study is divided in to macro and micro platforms.

First platform is macro analysis. It evaluates macro level factors influencing the determination of the magnitude of IRS and NIM in Sri Lanka. Followed by other researchers, under the macro economic variables basically the impact of interest and inflation on NIM and IRS are evaluated. For this purpose annual treasury bill rate, point to point inflation rate measured through Colombo Consumer Price Index are considered as independent variables. Therefore, this analysis would followed by a discussion in order to capture some qualitative characteristics influencing on these two variables.

The next platform is micro analysis which examines major players in the banking sector and determinants of their IRS. It is based on six largest domestic commercial banks, consisting of the two state banks and the four largest domestic private commercial banks. These six banks are referred as the Systematically Important Banks (SIBs). The variables which will be used in this analysis are; cost to income ratio, loan loss provision and non-diversification of income sources.

Result

There is a significant relationship between IRS and the macro economic variables such as interest rate and inflation. IRS tends to become wider in a rising stage of a real rate of interest and inflation.

It is evident that six SIBs are dominant players in the oligopolistic market. In terms of deposits, the SIBs held a market share of 83 percent from the banking sector deposits (CBSL, Annual Report, 2007). The selected determinants show considerable impact towards IRS. The industry cost-income ratio is improving constantly over the years. However, two state banks are yet to reach the benchmark ratio of 60 or below. Commercial banks are increasingly depending on interest income. The significance of fee based income is diminishing as the other income is growing at a slower pace compared to asset growth and income growth. The cost of loan loss provisioning is quite significant to the commercial banking system. It amounted to 25.2 percent of net interest income of the commercial banking system in 2002, but improved constantly to 11.9 percent in 2007 (as evidenced by Annual Reports of CBSL and Annual Reports of relevant Commercial Banks).

Conclusion

It was found that IRS is comparatively high in the country due to high operational costs and heavy dependence on interest income due to non diversification of income sources. Bank of Ceylon (BOC) and People's Bank (PB) are the market leaders in terms of total banking assets. At the beginning of this decade BOC and PB accounted for about 47 percent of total commercial banking assets in Sri Lanka. Both banks are considered as market leaders due to state patronage, large geographical distribution of branch network and large customer base. Some inefficiency that exists in the state banks is adversely influencing the IRS. As a result of that, industry paves the way for high profitability of private banks.

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