Reining the net interest rate margin.

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By Kevin Chew

Contrary to official signals, Prime Minister Mahathir Mohamad announced a 50 basis point reduction in the central bank's intervention rate to 4.5 per cent. This was part of the RM7.3 billion economic stimulus package to cushion a slowing economy affected by the SARS outbreak and the anaemic global demand. Economic conditions, in particular consumption demand, have weakened noticeably. Key indicators of consumption spending such as car sales, consumption credit demand, credit card spending, the import of consumer goods have all been losing ground in recent months. In addition to the weak economic conditions locally, the downward trajectory of US interest rates has resulted in wide interest rate differentials in favour of the local rates, providing some elbow room for local rates to be lowered. In addition, the benign inflationary reading, despite the sharp depreciation of the ringgit exchange rate, provides Bank Negara the flexibility to ease monetary policy further.

With that cut, the ceiling base lending rate (BLR) for both the commercial banks and the finance companies will be reduced to 6 per cent and 6.94 per cent respectively, from 6.42 per cent and 7.46 per cent respectively. Like the exchange rate, the interest rate mechanism provides a crucial channel in the transmission of the monetary mechanism for a change in monetary impulse to affect aggregate demand, assuming that the transmission system is efficient. The role of interest rates, as a monetary tool, has become even more prominent since September 1998 when Bank Negara opted to peg the ringgit exchange rate to the US dollar, relegating the latter to a passive mode. The recent reduction in the intervention rate is described as a pre-emptive exercise, which together with other measures in the economic package, are expected to enhance consumer confidence and spending to support domestic economic activities. Already, some of the money, in search of better returns, have ended up in equity investment, as seen in the recent 10 per cent rise in the KL composite index.

Did the cut in rates come a bit late? After all, the Iraq war is long over, and the threat of the SARS outbreak appears to be in retreat regionally. In addition, interest rates, in theory, are known to affect the economy only after a lag of about three to six months. Whilst this debate is still on going, another issue of interest is whether the net interest margin that banks (officially defined as the difference between the interest rate charged on loans and the rate paid on deposits and borrowed funds but, in this article, the cost of funds are proxied by the 3 month fixed deposit rate) are sitting on, despite the recent squeeze, is still too high.

The sequence of events following a policy announcement to cut interest rates (either a reduction in intervention rate or in the statutory reserve requirement) has become all too familiar and predictable in recent years. The flow of events starts with Bank Negara cutting interest rates to be followed quickly by banks lobbying for a reduction in fixed deposit (FD) rates to minimise the impact of lower lending rates on their bottom lines. And Bank Negara would eventually agree to a reduction. This time, a day after cutting the intervention rate, Bank Negara gave their blessings for banks to lower deposit rates by a maximum of 30 basis points but with the advice that the adjustments be kept minimal. If banks were to cut deposit rates by that quantum, then the overall spread would have narrowed by only 10 basis points.

Indeed, net interest rate margin for the banks has been kept high since the onset of the Asian Crisis. While Danaharta, Danamodal and the Corporate Debt Restructuring Committee have been credited for being instrumental in turning the banking sector around by helping them to get rid of some of the non-performing loans and strengthening their capital base, little credit has been given to the role played by depositors. Playing a big part in bailing out the banking sector from the excesses incurred during the run up to the Asian Crisis, depositors saw their returns on savings falling sharply from 1997 to 1999. During this period, the average lending rate fell by 376 points as a result of the progressive reductions of the statutory reserve requirement and the lowering of the intervention rate. But the fall of deposit rates was even faster. Driven down by excess liquidity in the banking sector, the average 3 month fixed deposit rate offered by commercial banks during the period fell by a sharper 573 basis point. As a result, banks' net interest margin has risen significantly from 2.45 per cent in 1997 to 4.42 per cent in 1999. In the face of weak loan demand, the banking institutions, aided by these high spreads, were able to shore up their balance sheets and recapitalise. Since then, margins have narrowed, albeit gradually, to reach 3.2 per cent in 2002. Even then, the spread is still higher than the average of 2.6 per cent recorded during the boom years of 1990 to 1997.

Is there any economic justification, really, to allow banks to continue passing on part of the cost of rejuvenating the economy to depositors? Would the banking sector be destabilised if they were to fully absorb the 40 basis points reduction in BLR? While it is clearly justifiable for depositors to lend a hand in recapitalising the banks during the crisis years, given that banking is a strategic sector that cannot be allowed to fail, it would seem a challenge trying to justify that now.

There is no doubt that the banking sector has made considerable recovery headway from the crisis years. The strength of the banking sector has been fully expounded many times over in official speeches propagating the fundamental strength of the Malaysian economy. The latest was a statement by Bank Negara when releasing its press statement on the reduction of intervention rate on 21st May. The central bank stated that a strong banking sector is one of the factors that provides Malaysia the policy flexibility to ensure that domestic sources of growth mitigate any worsening of external conditions.

Indeed, the strength of the banking system cannot be disputed. As at the end of March this year, with the improvement in the quality of assets and profitability, banks capitalisation continued to strengthen. The net NPL (non-performing loans) ratio, based on a 3-month classification, fell below 10 per cent for the first time since the onset of the Asian Crisis. And the risk-weighted capital ratio currently stood at a healthy level of 13.1 per cent.

This is further supported by the favourable profit announcements by the banks. Two and a half years after the onset of the financial crisis, the Malaysian banks turned around to record pre-tax profits for the first time in 1999. And according to the latest Bank Negara Annual Report, the banking system recorded a pre-tax profit of RM9.3 billion, or an extraordinary jump of 34.5 per cent from the previous year.

Amongst the East Asian countries, Malaysian banks still enjoy one of the highest margins. For example, in 2002, Malaysia's net interest margin of 3.2 per cent was higher than that of the Philippines (2.85), India (2.64), Taiwan (2.37), Australia (2.21), Hong Kong (2.07), and Singapore (1.83). Despite being way ahead of the curve in terms of sorting the post 1997 economic mess, its margin is higher even against the crisis-hit countries. Thailand, the epicentre of the Asian Crisis and a country that is slower with banking reforms, and South Korea have lower margins of 2.1 per cent and 1.94 per cent, respectively, in 2002. Both countries are believed to have suffered even more dire consequences during the Asian Crisis (including bank runs) needing a bail-out by the International monetary Fund (IMF).

While lower savings rate could encourage more consumption spending and increase trading in the stock market, it could, perversely, encourage the outflow of capital. The average fixed-deposit (FD) rate for commercial banks (three-month basis) stood at 3.2 per cent at the end of April this year. With inflation currently running at about 1.6 per cent, savers are getting only a minimal real return of about 1.6 per cent on their 3 month FDs. Compounding the low real returns on savings, the ringgit exchange rate, which is pegged to the US dollar at RM3.80 per dollar, has been depreciating against major currencies. To date, tracking the depreciation of the greenback, the ringgit exchange rate has depreciated by 18 per cent against the British pound compared with the prevailing rate in January last year. During the same period, it has also depreciated by 7 per cent and 12.7 per cent against the Singapore dollar and the Japanese yen, respectively. Against the Euro, it has depreciated by about 10 per cent at the end of May compared with the prevailing rate at the end of last year. In the absence of a re-pegging, the local unit is anticipated to continue to drift downwards, owing to the expected long-term weakening of the US dollar.

These developments could possibly encourage funds, seeking better returns, to flow overseas. Despite having in place capital controls limiting local residents from taking their money out of the country, depositors can still find ways to skirt around the regulations as capital control loses its effectiveness overtime. A significant outflow would reduce the country's external reserves and could again put pressure on the ringgit peg.

Although one of the lessons learned from the 1997/98 crisis is that a proper risk management system is vital for the attainment of long-term profitability, banks these days are perhaps a bit too guarded with their lending practices. This partially explains why actual loan growth has consistently fallen short of the 8 per cent target in recent years. A risk adverse banking sector could also reduce the effectiveness of a lower interest rate regime in revving up the economic engine.

What if the banks were to bear the full brunt of the reduction in intervention rate? A narrowing of the interest rate spread will, no doubt, squeeze banks' margins and lower their earnings prospects since it is a key factor in how banks make money. But it will surely not be to the extent of destabilising the banking system. The earnings per share (EPS) growth for selected banks this year is estimated to rise by a conservative 12 per cent, not a bad performance in view of the difficulty the economy has endured thus far this year. As for the calender year 2004, assuming a modest improvement in economic activity, the EPS growth is estimated to be about 20 per cent. Absorbing the full downward adjustment in intervention rate would reduce earnings by about 7 to 15 per cent for most banks. Even factoring a 15 per cent reduction, the EPS growth would probably still be at double-digit level.

Furthermore, squeezing the margins more may also work to encourage banks to work harder to improve operational and cost efficiency, factors crucial for local banks to remain competitive post liberalisation. Lower margins could also hasten the second phase of the merger process by forcing the weaker banks to merge with the stronger ones. In addition, it could pressure the banks to come out of their comfort zone, take a bit more risks and work harder to grow their loan books by broadening the scope of their lending activities to other sectors.

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