On a Bank Interest Rate Policy under Liberation Trend

by MEcon. ĐẶNG THỊ NGỌC LAN

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The Government has so far decided that the interest rate should be established under the market mechanism. The State could take economic and financial measures to regulate the supply of and demand for capital but it should ensure that the deposit rate is higher than the inflation one, the loan rate is higher than the deposit rate. Subsidy in form of credit is cut, which means that all commercial banks should take care of their own business and supply services to all customers without discrimination.

Ten years after the economic reform, the interest rate system has been adjusted to the market mechanism. It has been liberate step by step with a view to making it suitable to local conditions.

This system, however, still contains shortcomings and fails to cope with fast developments. It can't play well its role in regulating the economy and smooth flows of investment needed for the industrialization.

1. Directions for the interest rate policy of commercial banks

The interest rate policy must deal with relations between tasks of controlling the inflation and ensuring the planned growth rate, between interests of the whole economy and of banking institutions, and between depositors and borrowers.

A flexible, efficient and diverse interest rate policy for commercial banks under the SBV control must be based on the following principles:

- The interest rate must change according to changes in the supply of and demand for capital, thereby ensuring interests of both depositors and borrowers. It's worth noting that depositors put their money in banks for banking services, not for some interest payment.

- The interest rate must be a healthy instrument for competition and a lever for promoting loan quality and reducing credit risks.

- The interest rate is an instrument for implementing the monetary policy and orienting mobilized capital towards investment projects and industries in need of support.

When the interest rate is liberated, the interest rate based on market forces requires the following conditions: macroeconomic stability, a safe and healthy banking system, and a reasonable profitability for the banking sector.

Under a system of agreed-upon interest rate, the interest rates for commercial banks could be controlled according to the following directions:

+ Lending rate: a ceiling for lending rate could be set and used as a source of reference, and the SBV need not fix any official rate.

+ Deposit rate: a deposit rate ceiling could be fixed for all banks in all zones of the country, and branches could set their interest rate so as to be appropriate to local conditions.

+ Discount rate: The rate charged by the SBV on member banks for loan must be based on the market rate and could be adjusted to changes in the market forces. This rate could be based on maturity of loans.

+ Commercial banks could base their loan rate on creditworthiness of customers in order to gain the best profitability ratio.

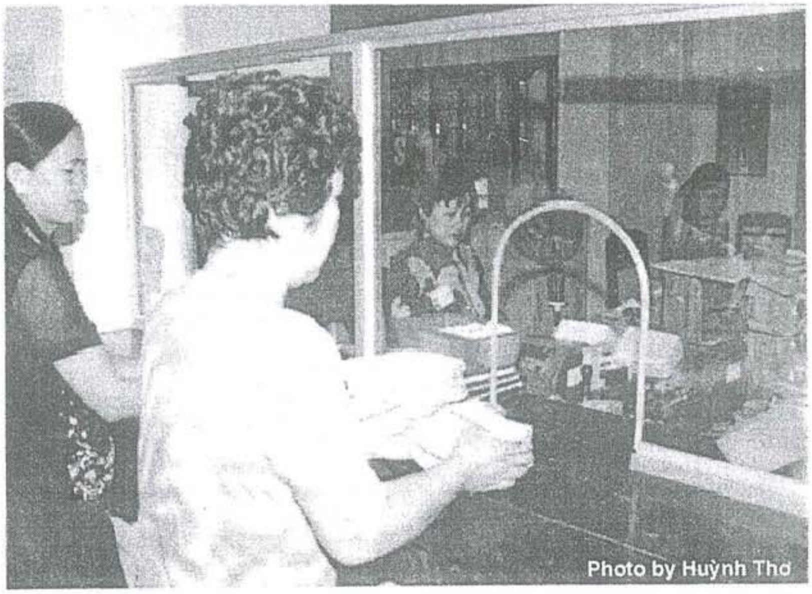
2. Regular adjustments to the loan rate

In commercial banks, a reasonable policy on interest rate must aim at reducing overheads and interest rate risk. Under the market mechanism, however, changes in market forces and production factors affect greatly the interest rate. It's necessary to analyze factors of the interest rate on a regular basis in order to adjust it to current conditions. This practice will help the SBV reduce the gap between deposit and loan rates and allow commercial banks reduce the overheads and stay competitive.

The analysis of interest rate should be concentrated on the following factors:

- Business climate and development prospects: When the business climate is favorable, the bank interest rates are usually low because degree of risk is low and profitability ratio is acceptable. On the other hand, the interest rate will rise when the economy isn't stable because high rates will help banks attract depositors. Bright prospects of economic growth will lead to higher demand for capital and higher interest rates, and things will happen in the opposite way when the economy develops badly.

- Market rate: If the interest rate offered by banks is much different from the market rate, the banks won't attract depositor (when the rate is too low) or borrowers (the rate is too high). The more reasonable the interest rates are, the more business projects are carried out, and the banks could supply more loans and earn more profit.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- Interest payment: This includes interest payment for loans the banks get from depositors and other banks. The use of bank loan affects the bank deposit and required reserve. Because the required reserve and interest rates are changeable, the banks should analyze overheads in order to find ways to reduce the interest payment, thereby increasing their profits.

I suggest here a formula to work out the interest payment per loan:

$$Z = \frac{\sum_{i=1}^{n} (AxB) - (CxDxE)}{F}$$

Where A: deposit rate

B: bank deposit

C: total bank deposit

D: required reserve ratio

E: interest payment for the required reserve

F: total bank loan

- Overheads: Besides the interest payment, the banks should cover expenses of running their business. These expenses must be well under control because they affect the loan rate adopted by the bank. Analysis of overheads could help reduce unnecessary expenses. The following formula could help calculate the expenses of a loan supplied.

$$\text{Expenses of aloan supplied} = \frac{\text{Overheads in a fixed period}}{\text{Total bank loan}}$$

- Average profitability ratio: When the loan rate is higher than the profitability ratio, companies tend to deposit their money with the bank instead of investing in their business, which lead to capital surplus and losses to the banks.

To keep the loan rate lower than the profitability ratio is no easy task because this ratio changes over industries and time. To work out the exact profitability ratio requires a lot of information and careful investigations. Moreover, the banks should pay attention to the inflation rate because it affects greatly the profitability ratio.

3. Control over the interest rate when it is liberated

The liberation of interest rate allows commercial banks more autonomy in doing their business and provides a basis for the formation of the market rate. This situation leads to lower interest rates, which could encourage companies and individuals to engage in production and services. The liberation of interest rate, however, only produces good results when commercial banks are strong enough to control risks, ensure loan quality and work out a reasonable policy on the interest rate.

Many banks have paid too much attention to other managerial methods (careful investigation before deciding on the supply of loan, financial investment, etc.) and neglected the task of building a policy on the interest rate which could attract deposits to various accounts and diversify form of bank loans, thereby maximizing the profit and reducing costs and risks.

At present, the banks are facing many risks of high degrees when the interest rate is liberated: (1) There is a great difference between the supply of and demand for long-term capital which the result that the banks have to turn short-term deposit into long-term loan, (2) Increases in deposits and loans in the dollar may lead to exchange risk when the exchange rate changes, and (3) The deposit rate was made higher in 2004 when the CPI reached 9.5% while the loan rate stayed the same, which reduced the profit of the banks.■


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