Commercial Bank Interest Rate Spreads in Jamaica

-Measurement, Trends and Prospects-

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EXECUTIVE SUMMARY

1. Commercial bank lending rates are important concerns to policy makers because they have a fundamental impact on investment. The size of banking spreads – the difference between deposit and loan rates - also serves as an indicator of efficiency in the financial sector. Some of these costs and risks are imposed by the macroeconomic, regulatory and institutional environment in which banks operate while others are attributable to the internal characteristics of the banks themselves. The objectives of this paper are to establish the time path of banking spreads in Jamaica and the main factors influencing the level and direction of spreads.

2. Most discussion on interest spreads in Jamaica is based on the difference between the average loan rate and the average deposit rate as published by BOJ. This *ex ante* approach to measuring spreads is unsuited to the objectives of this paper for several reasons: (i) the published spreads use the average rate on time deposits as the representative deposit rate, ignoring the lower rate paid on savings and other deposits. Given the preponderance of savings deposits in bank liabilities, the published spread would thus tend to understate the actual spread. (ii) Even when a correction is made for this, merely citing the difference between deposit and lending rates does not take account of the allocation and quality of a bank's portfolio and could easily lead to wrong conclusions about its profitability. The deposit-loan spread would be especially misleading where a significant portion of assets are non performing or have been placed in other investments.

3. The analysis therefore focuses on a spread computed from actual interest earnings and expenses. The profit and loss account yields information on the structure of intermediation costs, asset/earnings distribution and asset quality.

This *ex post* measure of banking spreads also allows for international comparison of net interest margins and intermediation costs.

4. By this *ex post* measure, interest spreads in Jamaica averaged about 8 percentage points in the 1980s but widened sharply to 21.8 points in 1992 and have averaged 17.6 points in the 1990s. Quarterly data to September 1999 (Table 3) show the spread rising from 10.8 points in 1998 to 16 points in the September quarter. The pattern is broadly similar to published spreads.(Table1).

Factors behind Jamaican Spreads

5. The absolute size of banking spreads in Jamaica is an outcome of the factors that have defined the economic environment as well as internal characteristics of banks. An extended episode of double-digit inflation over the review period put a floor on deposit rates that exceeded 10%. This became the base on which intermediation costs were added to arrive at the lending rate. The structure of interest rates has been reinforced by the steady supply of Government instruments that have competed for deposits on the one hand while setting a benchmark for lending rates on the other.
6. Risks related to the economic environment – e.g. the exchange rate risks, information, default - are difficult to quantify but are reflected in a widening of spreads when there is macroeconomic instability. Other aspects of the operating environment that increase banking risk relate to loopholes in the legal and institutional framework and are manifested in poor corporate governance, fraud and corruption. Reserve requirements that are high by international standards have also played a role in determining banking spreads.
7. In examining the Jamaican data, the focus was on separating the cost of the cash reserve requirement as a cost imposed by policy. During 1997 and 1998 when loan rates were 23.4% and 20.5%, the estimated contribution of the reserve requirements to loan rates was 3 percentage points. Although high by

international standards, the reserve requirement added a relatively small margin over deposit rates. A cash reserve requirement of 10% in 1998 would have reduced the spread by less than 2 percentage points. Much of the spread appears to be related to bank overhead costs.

8. Using the assumption that the interest spread mirrors the structure of bank costs, the spreads observed over the past three years can be decomposed as follows:

	1997	1998	1999 (Sept)
Avg Deposit Rate	9.2	9.7	6.8
Avg Loan Rate	23.4	20.5	22.8
Spread	**14.2**	**10.8**	**16.0**
Cash Reserves	3.0	3.0	1.4
Operating expenses	10.2	6.9	9.1
Loan losses	4.4	1.5	1.2
Other costs	0	-0.2	0.6
Profits	-3.4	-0.4	3.7

9. Operating costs (9.5% of assets in 1998) were found to be two to three times higher than international standards. Staff costs were about two times as high and non personnel costs have been rising. These comprise occupancy costs (rental, maintenance, security), professional fees (legal advertising, auditing), data processing, stationery, etc. It is these areas of overhead and operating costs that are amenable to savings from mergers and rationalization.

Outlook

10. The prospects for a decline in interest spreads rely on a mix of policy and microeconomic elements. On the macroeconomic front, the chief requirements are a continuation of low and predictable inflation and relative exchange rate stability. The level of Government borrowing and its influence on money and credit markets is an element of macroeconomic policy that

imposes constraints on the flexibility of interest rates. The medium term outlook for balanced budgets and a net reduction in domestic debt augur well for declines in loan rates and bank spreads.

11. Policy also needs to address the legal and institutional infrastructure on which the banking system rests. In particular, the incidence of fraud, the ease with which bad credit risks survive due diligence and the state of corporate governance are transmitted to higher operating costs and asset deterioration. There is an urgent need to enhance the capability of the authorities to detect and prosecute cases of fraud and to revise and implement the legislative framework governing corporate management and accountability, tax administration and credit information.

12. The cash reserve requirement has been ascribed too large a role in explaining the high interest margins in Jamaica. The analysis shows that even if reserve requirements were abolished, the impact on current loan rates of about 22% would be no more than 2 percentage points. This limits the role of reserve policy in influencing loan rates over the medium term although further reductions will contribute to the efficiency of intermediation.

13. The degree to which banks are able to operate profitably on a lower spread is an issue of operating efficiency. It raises the question of optimal size of banks and branch networks. Where the need for efficiency improvements is driven by the demands of shareholders, the prospects for change are brighter but are likely to include a tradeoff between providing service through a wide branch network of branches versus more limited service through fewer but efficiently sized branches. Some features of consumer banking in the USA which contribute to their lower operating costs – ATM banking, point of sale debits, home computer banking etc. – are enjoying increasing use in Jamaica but the general picture is one of a large number of bank branches spread throughout the island. It is clear that the restructuring of the banking system requires more than mere re-capitalization and regulation but will require internal reengineering and the extensive application of available technology if the cost of inefficiency reflected in banking spreads is to be reduced.