The difference between lending interest rate and funds interest rate. Link with sustainable banking. Particularities of Romanian Market

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Abstract: *The article, is trying to capture the way difference between active and passive interest rates influence macroeconomic sustainable development in a country. However the theory is limited on this area and the author is intending to merge practical aspects with conceptual terms.*

The role of banks in an economy is very important, as all inflows and outflows are done through financial institutions. Bank sustainability is the area of study and practice that captures the contribution of banks in sustainable development of a country. Banking instruments are the means by which banks are present and act in the economy. Banking techniques are the mechanisms of banking instruments. The most important banking instruments are the loans and the deposits. So banks take deposits from different entities and use them as resource to finance other entities. A bank is considered contributing to sustainable development, if lending divisions allocates resources to investments that bring long-term welfare to the community not only for today people, but for future generations. Therefore, we can establish a correlation between banking sustainability and sustainable development through the evolution of banking instruments.

Looking to detail, bank sustainability is highly affected by the local macroeconomic issues, but also from global influences.

Key words: Transfer pricing cost, transfer pricing income, sustainable banking, reference rate.

Motivation

The challenge of banking sustainability is very suggestive described in the company's vision of Triodos Bank, one of the bank that is exclusively dedicated to sustainable development, which is done beyond the declarative attitude - often visible within majority of the other banks. One of the Board members says: "Triodos Bank promotes the dignity of human and environmental conservation focusing on people's quality of life. The key to success is responsible attitude to business, transparency and conscientious use of money. Triodos Bank offers banking sustainability through products and services that directly promotes sustainable development. This in turn creates a society that enjoys a better quality of life. "

The study of sustainability in banking can include specific issues or the classical ones:

➤Differential between the active and passive interest rate. As this difference is smaller, the more transparent the contribution of banks in sustainable development of economy is;

➤Relationship between short-term financing and long-term financing;

➤Relationship between lending in local currency and in foreign currency

➤Risk management;

➤Financing green project

The intention of the author is to reveal the magnitude of the impact at macroeconomic and microeconomic level of the interest rate differential between loans and deposits.

The concept of "the difference between active and passive interest", using the most simple definition is the expression of the balance of the interest rate charged by bank for the interest rate on investments and the interest rate paid by the bank for the funds attracted.

But, with the purpose to capture the essence and also in order to ease the understanding of the importance of the diversified effects in an economy generated by the difference between active and passive interest rate, we have to identify the components of our indicator.

The beginning of the analyze, is to get a bird eye overview of the mechanism behind the concept. Thus, banks receive interest revenues from customers and pay interest expense also to customers. If ignoring commissions, the net result is the operational profit margin. Furthermore the bank need to cover the risks costs (credit risk, currency risk, interest rate risk) and administration cost resulting the net profit. The sustainability issue appears in the situation where the bottom line, i.e. net profit, is excessive high, compared with the return in other sectors of economy. This is due to the fact that the interest revenues are high, while the interest expense is too low, meaning that the banking sector in such economy has a monopolistic position on both sides lending and depositing. This is an anomaly of the banking system and in the long run, such an unbalance will not bring sustainable development.

Why this happened? How is possible that banks have interest revenues so high? Who is bearing this? Why the banks offer so small compensation for the resource attracted?

The way to get inside this deviation is to identify the elements that compose the differential between the active and passive interest.

As already mentioned, interest revenues need to cover the cost with deposits and to ensure a profit after deducting administrative expenses. But the mechanism inside the banks is done through a treasury department which perceives a cost to lending and is paying revenue for the resources attracted. The instrument which is behind this process is the banking transfer price instrument. In theory, transfer price is often met as a fiscal tool. The role in the banking area is more sophisticated and the transfer price used is established through internal bank policies. The reason is related to the fact that the banking internal transfer price behave in a certain way depending on specific features of each bank.

Characteristics of the transfer price instrument are:

- The transfer price is the key tool which is determinant in computing the profitability of each business entity, or a product in a bank;
- The transfer price is governed by rules, procedures and internal policies. Particularly for banking sector each bank has specific regulations for calculating the transfer price;
- The transfer price is made up of a number of components which can be divided into a fixed (given and unchangeable subcomponents) and respectively in variable components;

So, the difference between active and passive interest rate is dependent on interest rate and on transfer price. Furthermore those core elements are dependent on other factors of influences. As it will be described each influence will create an additional cost/incentive on interest rate determining the level of the differential.

Factors of influence

The differential between active and passive interest rate, is influenced by a complexity of elements, but the major category is to split them in: macroeconomic factors and internal factors.

Macroeconomic factors could be fiscal policy or monetary policy. With regard the banking sector, monetary policy weight more than other macroeconomic factors of influence.

Monetary policy depends on: inflation, reference interest rate and the mandatory minimum reserve requirements.

Influence from inflation. The higher the inflation rate is, the more difficult is to control the market expectation and in consequence the banks are forced to include in their interest rate components a risk margin to cover the losses from inflation.

Influence from reference interest rate. Reference interest rate is the interest rate of a country monetary policy which is determined by decision of the Board of Directors of the Central Bank, in Romania the decision is taken by the National Bank of Romania. In a relative stabilized economy, key interest rate is meant to stimulate the economic growth and the community welfare.

The role of the reference rate is reflected in the formation of the base rate, as it is the starting point in construction of a level of interest rate, which in fact can be EURIBOR, LIBOR or ROBOR.

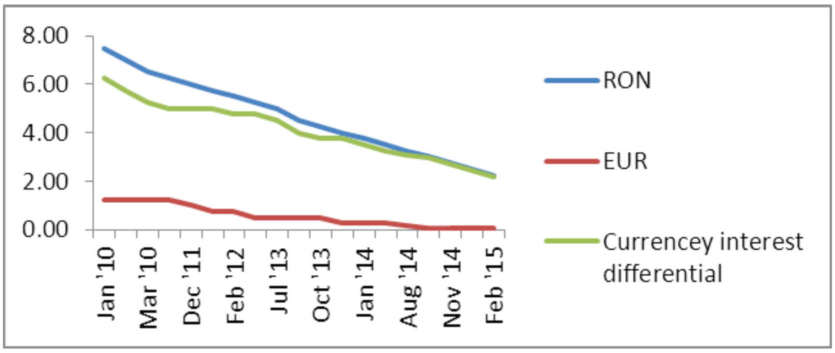
Reference rate creates a double impact:

➤firstly, direct impact on the resultant of the differential between the active and passive interest rate;

➤on the other hand creates a preference on foreign currency lending, which consequently brings negative effects on the national currency. This impact is found also in the differential between the active and passive in the sense that, if maintained at a high level allows commercial banks to benefit from a wide range of market manipulation tools in establishing the interest rate. From recently banking practice, if looking at Romanian market, in order to maintain the profitability as high as possible or for covering the provision for bad loans, banks are keen to benefit from a high level of reference rate.

In conclusion, this factor represents one of the given and unchangeable element which is part of interest rates composition. In our country even if the last years prove a downtrend for these indicators, if compared to the region, remains at a high level.

In the chart below is presented the evolution of the interest rate differential between the rates of reference name in RON compared to rates in EUR



Source: Statistics from NBR, ECB

Influence from minimum reserves requirements. As defined by the Central banks minimal reserve requirements (MRR) is the amounts blocked at the national bank accounts of the commercial banks in a certain quota, on hand of credit institutions in domestic and foreign currency, with the very clear purpose of limiting uncontrolled bank expansion activity. The National Bank of Romania states that, "MRR function is the main mechanism of monetary control (which is closely correlated with the liquidity management by the central bank) and the stabilization of interest rates on the interbank market. The major role of reserve requirements in foreign currency is to mitigate foreign currency credit expansion ".

Thus, the minimum reserves become placement in central bank accounts remunerated with a low interest.

Those resources are locking legal reserve requirements are part of a bank's total market funds raised from clients that are gathered for a cost supported by the bank, as interest expense. To pay this cost commercial bank must make investments with the remaining available funds after part of the resource is in MRR accounts which need to ensure a return to cover the cost of attracted resource. So, indirectly this creates an additional pressure on customers interest rate that is translates into a possible increase of the differential between the active and passive interest rate.

For the purpose of profitability, banks use MRR as another reason to keep the lending interest rate up, while the deposit rate is low, which conduct to a difference between them unreasonable high, neglecting the effect on created on the other sector of activity or the entire community.

Internal factors. The most significant contribution is the transfer price as a link between the mother company and the subsidiary of the parent company.

The transfer price is the instrument by which these revenues are transferred to the parent bank. This is nothing unusual, as are common rules of the market economy. Imbalance lies in when the subsidiaries are pushed for huge profits, in detriment of the pressure on customers that need to bear important financing cost.

In every bank, transfer pricing decisions are taken by the Committee dealing with asset and liability management, met name ALCO (Assets and Liabilities Committee)

The transfer price is determined by management policies as follows:

- For private banks with foreign capital contribution, transfer price is established by the parent company;
- For private banks with private and state owned capital, by headquarters.

The core in-house analysis of profitability is done through transfer price computation. The internal workflow considers the profitability per each type of product, classified function of currency, volumes, terms and also on destination retail or corporate. The logic is different in case of loans compared with deposits. Lending represents a division and deposit another division. Treasury is the matching entity. Transfer price is deducted from interest revenue to compute a profit margin. Furthermore Treasury receives revenue from lending division while deposits receive revenues as providers of resource.

This is how it works a standard banking mechanism, but can help understanding the source of the pressure on the customers.

Divisions fight for their operating profit margins, and in case the mother company associated with the contextual influences set high level of transfer rate, than the solution is to push on interest rate, up for lending, down for deposits.

So the pressure creates pressure. Executive managers of the banks to safeguard their positions and bonuses are under pressure to bring profit and so they induce pressure in the market. Therefore, the transfer price play an important role, is the instrument of the banks to take decision, and at the end to determine the difference between active and passive interest rate.

The transfer price is composed of fixed elements and of variable elements. The fixed elements are that one given by the regulators. Also transfer price differ if computed for loans and if computed for deposits. There are also common elements for both deposits and loans.

The first component is the BOR rates which is the base for loans and for deposits. This rate is classified depending on the currency and on the term of the instrument.

Cost with MRR is another fixed element

of transfer price. This has been explained already.

Another fixed component of transfer price given by the regulator is the cost related to the guarantee fund. This component appears with the role of cost, meaning that transfer income diminishes. It is calculated as a percentage of the average volume of deposits recorded at the end of previous year.

Cost with cash in ATM or respectively the other cash that exists in an economy is also a fix component. Basically the logic behind is that cost is the same as for MRR cost. The cash comes from various resources which bear interest expense, that need to be cover by the revenues from lending interest rate.

Above all of fixed elements comes the contribution from variable elements.

The first one to mention is the country risk. This represents an additional cost controlled by the bank Head Office, which encompass an abstract vision of the bank which has foreign investment in an oversees country. This cost contains a very subjective approach to the mechanism of the transfer price policy of a bank. A short example can clarify this. A bank owned by Greece has a subsidiary in Romania. There is no comparison between those two countries in terms of macroeconomic stability, monetary policy, external debt, constant GDP growth. But the Head Office from Greece includes in the transfer pricing computation a cost related to country risk.

The cost of procurement of currency other than the EUR and local one, like for example CHF, involves an additional cost justified by the transactions to purchase that currency through a SWAP. This component varies depending on the liquidity of the market. Most frequent is called the "SWAP cost basis".

Finally the spread which is justifying the profitability as the core purpose comes with an additional cost. This is highly variable and dependent on the market conditions whether the bank intends to gain market share or not.

All in all, not claiming that the exposure is exhaustive those are the major elements of impact in constructing the interest rate. The mechanism described is the same in any bank.

Conclusions

The differential between the active and passive interest rate is a consequence of how a banking system maturity degree is driven by the monetary policy instruments. However, the general economic context through the rest of economic policies (fiscal, budgetary, the labor market etc.) is also a contributor to the evolution of the active and passive differential.

Simple information regarding this differential is not sufficient to conclude whether or not banks promote sustainable development. Why? The reason could be that this indicator is only related to operational profit. In order to find a rate of return of bank, there must be considered the provisioning expenses and all the other administrative expenses.

In the table below it is visible the evolution of the differential, which is in a downtrend up to 2013, but re-launched in 2014, so the concern of this study is still an issue.

Currency RON	2010	2011	2012	2013	2014
Average interest rate for deposits retail	6.80%	6.10%	5.64%	4.83%	2.40%
Average interest for consumer loans retail	20.90%	17.75%	15.80%	13.95%	12.37%
Interest rate differential	**14.10%**	**11.65%**	**10.16%**	**9.12%**	**9.97%**

Source: Own computations

Is it possible to have a sustainable development in a country where the profit is concentrate in a one single sector?

If this induces a net profit rate of return than the average from the other sectors of economy, it means that interest rate differential is high and the revenues collected by the bank creates a polarization of profit within the banking domain within an economy. Taking the analysis further, this creates an imbalance with the other sectors by diminishing the capacity of the real economy to expand because they do not have financial power or ability to generate profit.

Two important conclusions can be drawn:

➤The first conclusion is that in a free market, it is difficult to impose a maximum limits for interest charged by banks and if these interests are unjustifiable high, the contribution to sustainable development is diminished. It is up to banks management as manifested in the market, but it is mostly guided according to the objective of maximization of benefits.

➤The second conclusion that can be drawn, given the current context of international banking systems, the banks must pursue their profitability policies through volumes increasing which is a more long time view and more beneficial for the entire economy. This comes instead of a short time horizon with high profits, but that may come with reverse consequences mostly in terms of risk management. The bank that foresee this approach as an opportunity will ensure:

- income on a time horizon is sustainable
- good market image
- strong market share

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