

INTEREST POLICY OF COMMERCIAL BANKS IN SLOVAKIA

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Interest as the price for the provision of capital, or interest rate, which affects it, is one of the most important management instruments of commercial banks. Active as well as passive operations of commercial banks are in fact connected with the receipt or paying of interest, the amount of which is influenced by several factors. One of these is the situation on the money market where banks acquire the necessary resources and allocate the temporarily free financial resources. In the case of a surplus of money in the economy interest rates on the money market have a tendency to decline and vice-versa, in the case of a shortage of money they have a tendency to rise. Besides this, the situation on the money market is influenced also by monetary policy measures of the central bank, which affects the supply of money in the economy through a change to interest rates.

Since 2000 the National Bank of Slovakia (NBS) has operated monetary policy in particular by means of setting the key interest rates for one-day sterilisation and refinancing operations and by setting the limit rate for standard two-week repo trades. For the commercial banks the official interest rates of the central bank represent the marginal cost of acquiring resources and besides that they may use them as reference rates for setting client interest rates, and therefore they directly affect their interest policy.

From an analysis of the impact of changes in key interest rates of the National Bank of Slovakia on client interest rates on loans and deposits it can be seen that NBS monetary policy measures in the form of a change to key interest rates significantly affect in particular short-term client interest rates. A change to the central bank's official rates is first shown in a change to rates on the money market and only subsequently is reflected in changes in client interest rates.

Money market rates react to changes in the NBS key interest rates almost immediately, where their reaction in the first months following the change is more significant than the change in the central bank's rates and culminates in the second month following the change. In subsequent months there occurs a certain correction to the significant change and creation of an equilibrium status. Client interest rates on short-term loans react to changes in NBS interest rates more slowly, as a rule with a month's delay, culminating five months after the change having been made and their change is more marked

than the change to the central bank's rate. In the following period a correction to the excessive reaction takes place and interest rates head towards an equilibrium state. Client interest rates on short-term deposits also react to the change in the central bank's rate with a monthly delay, culminating three months after the change having been made, nonetheless, their reaction does not exceed the change of the official interest rate. In the subsequent months the development of client interest rates on deposits is corrected by the impact of the money market rates, and later they head towards an equilibrium state. [2]

In comparing the reaction of client interest rates and that of money market rates to the change in key rates of the central bank we find that the reaction of client interest rates is, compared to the reaction of the money market rates, less marked and is distributed over a longer period. Client interest rates of commercial banks are thus affected over the short term by money market rates and over the long term by the central bank's key rates. As the National Bank of Slovakia has over the long term been gradually reducing key interest rates, commercial banks have been reacting to this by decreasing their client interest rates. More specifically said: the average interest rate on the balance of short-term loans of commercial banks in Slovakia are gradually falling and approaching the level of the one-day refinancing rate of the NBS, whereas interest rates on short-term deposits in commercial banks are falling more significantly than the rates on loans and are progressively coming closer to the one-day sterilisation rate of the NBS.

Another important factor affecting the level of interest is the risk of individual banking operations. In relation to the bank's clients, risky operations are in particular credit operations in which the risk depends on the repayment period, the amount and method of securing the loan provided. The longer the repayment period and the higher the amount, the higher the risk is, and therefore also the interest is usually higher in the case of long-term loans and higher amounts than in the short-term loans and lower amounts. With a higher quality of security the risk on the other hand declines, therefore the interest may also be lower, if the debtor provides quality security to the creditor. Unsecured loans, although only for a short period are provided at high interest, since in the case of such loans the risk of default is high. Therefore commercial banks these days provide unsecured loans only rarely, due to their too high risk.

Besides risks resulting from credit operations, commercial banks are also exposed to other risks relating to the economic environment in which they operate. In transitional economies, of which Slovakia is one, a standard economic environment has not yet formed and therefore Slovak banks must face greater risks than their counterparts in advanced economies. The most significant of these is the risk of changes to interest rates on the money market, which may markedly influence a bank's economic management. In connection to this banks must deal also with the issue of the sensitivity of individual assets and liabilities to the change in interest rates.

Assets not sensitive to changes in interest rates comprise in particular loans with the fixed interest rate, liabilities not sensitive to the changes in interest rates are in particular the term deposits. Flexible interest-rate loans and interbank rates are very flexible and therefore also sensitive to changes in the money market interest rates. Sensitivity to a change in interest rates is also connected with the repayment period of assets and liabilities. With the approaching repayment period assets and liabilities not sensitive to changes in interest rates may become sensitive. For instance, fixed interest-rate loans during a period of high interest rates become sensitive to the development of interest rates, when they are replaced following their repayment by flexible interest-rate loans. Expectations of the development in interest rates on the money market affect also the repayment period of the securities portfolio. In the situation when interest rates are very flexible and uncertain, banks give preference to securities with a shorter repayment date and similarly in the case of deposits they prefer short-term products (made more advantageous via a higher interest rate) over long-term products. [5]

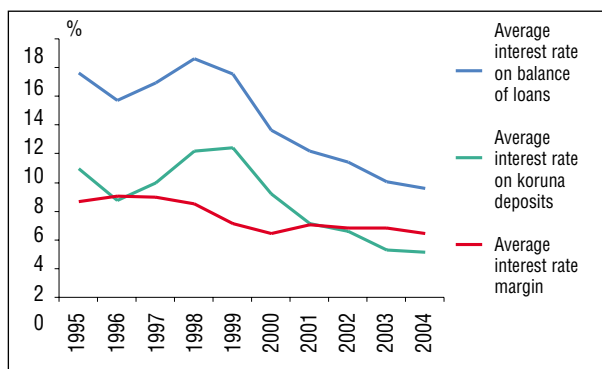
The economic management of a commercial bank is reflected also in its balance sheet, which compares bank's resources (liabilities) and their use (assets). Banks endeavour to obtain the necessary resources, i.e. to make passive operations with minimum costs and to use the resources obtained, i.e. to make active operations with the maximum revenues. The bank's profitability thus depends on the balance sheet structure, although this is directly affected by the share and structure of revenue assets which comprise in particular loans, interbank active deals and securities operations. Effectiveness of the bank's economic management is no longer now dependent only on its ability to turn resources acquired into revenue-making assets, as it used to be the case in the past, but on the successful management of assets and liabilities, the aim of which is to optimise their structure in

Table 1 Average client interest rates of commercial banks in the SR (%)

Indicator	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Average interest rate on the balance of loans	15.64	13.74	14.93	16.65	15.55	11.66	10.22	9.43	8.07	7.47
Average interest rate on koruna deposits	9.00	6.71	7.98	10.16	10.45	7.23	5.15	4.60	3.28	2.94
Average interest-rate margin	6.64	7.03	6.95	6.49	5.10	4.43	5.07	4.83	4.79	4.53

Year 2004 – first six months
Source: NBS and own calculations

Fig. 1 Average client interest rates of commercial banks in the SR



the interest of maximum profit, though at a reasonable level of risk. These days no commercial bank is able to operate without properly managing its assets and liabilities, where the task of such management is to adjust the balance sheet structure to changed economic conditions, i.e. to eliminate threatening risks, or harmonise assets with liabilities.

In the case of a commercial bank the amount of interest collected is not as important as the difference between interest paid by the bank for the use of borrowed capital and the interest received for the use of this capital in particular in the form of loans provided to its clients. The difference between interest received, which is usually higher, and the interest paid, which is usually lower, represents the interest-rate spread (interest-rate margin). The interest-rate margin serves for covering the bank's costs and is the main source of its profit, therefore receives appropriate attention from banks.

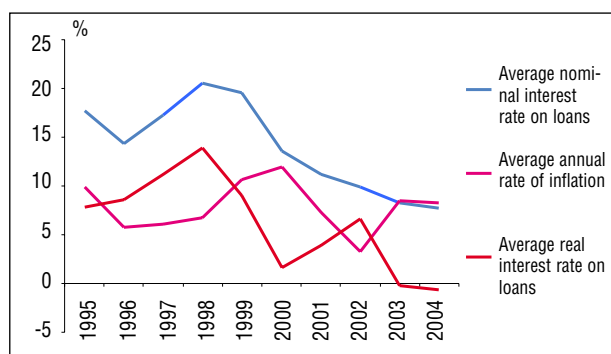
The level of commercial banks' interest-rate margin gives a picture of their management efficiency. Therefore banks in the countries with an inefficiently functioning banking sector, where these include also transitional economies, need a high interest-rate spread in order to ensure profitability. As is clear from table 1, Slovak banks have since 1999, when their cleaning-up and restructuring began, achieved a greatly above-standard interest-rate margin in the amount of 6 – 7%. However following the cleaning-up of the Slovak banking sector the banks still did not forego their high interest-rate margins. Though these were declining from the mentioned 6 – 7% in the second half of the Nineties to 4.5 – 5%, they have in the subsequent years, compared to the 3% common in the


Table 2 Average interest rates on the balance of short-term loans in the SR (%)

Indicator	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Average nominal interest rate on loans	17.72	14.34	17.30	20.59	19.60	13.61	11.24	9.93	8.29	7.49
Average annual rate of inflation	9.90	5.80	6.10	6.70	10.60	12.00	7.30	3.30	8.50	8.23
Average real interest rate on loans	7.82	8.54	11.20	13.89	9.00	1.61	3.94	6.63	-0.21	-0.74

Year 2004 – first six months

Source: NBS and own calculations.

Fig. 2 Average interest rates on the balance of short-term loans in the SR


European Union, remained high. Due to this Slovak banks achieve comparable, in some cases even higher, profitability than banks in the EU. This can hardly be attributed to their high efficiency, but rather high interest-rate margins they enjoy.

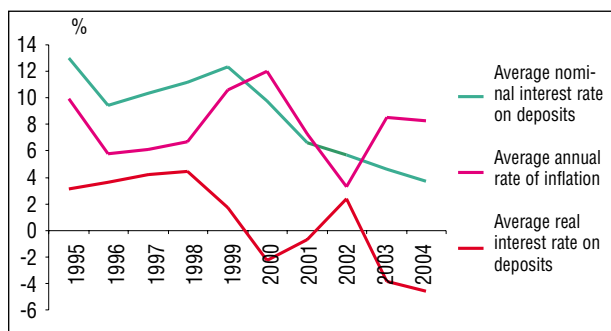
An important factor influencing interest rates is inflation. Investors are not simply interested in the nominal interest rates requested from them, or paid by commerci-

Table 3 Average interest rates on annual deposits in the SR (%)

Indicator	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Average nominal interest rate on deposits	12.99	9.43	10.33	11.17	12.34	9.76	6.62	5.70	4.65	3.72
Average annual rate of inflation	9.90	5.80	6.10	6.70	10.60	12.00	7.30	3.30	8.50	8.23
Average real interest rate on deposits	3.09	3.63	4.23	4.47	1.74	-2.24	-0.68	2.40	-3.85	-4.51

Year 2004 – first six months

Source: NBS and own calculations

Fig. 3 Average interest rates on annual deposits in the SR


al banks, but real interest rates affected by inflation in the given economy. In a well-functioning financial market interest rates should reflect also the forecast rate of inflation and commercial banks should take it into account in their interest policy.

Low, or even negative real interest rates advantage debtors, therefore in such a situation there is an increased interest in loans, however they harm creditors, therefore the interest in savings is declining. Vice-versa, high real interest rates attract depositors who increase the rate of savings, but they are disadvantageous for real investments, as they make loans expensive.

The situation in the Slovak financial market in 1995 – 2004 is documented by data in the following tables and graphs derived from them. In table 2 we can see the development of the average nominal and real interest rates on short-term loans, i.e. loans with a repayment period shorter than one year. On the basis of an of them it may be said that the situation in the loan market in period over 1995 – 1999 was not favourable for real investment, since nominal as well as real interest rates on loans were relatively high. This was caused by a shortage of domestic credit resources at the time, which were drawn up to 90% by the state. The situation changed in 2000 when not only nominal, but, thanks to growing inflation, also real interest rates fell significantly, now having remaining since negative 2003. This has created favourable conditions for granting credit for real investment, which has also been reflected in the growth of the volume of loans provided in the Slovak Republic.

The development of average nominal and real interest rates on annual deposit in the period of 1995 – 2004 is shown in table 3 and figure 3. Analysing them, we can see that both nominal and real interest rates on annu-

al deposits up until 1999 were relatively high, which was attractive for depositors and was reflected in the growth of the volume of deposits in this period. Growth in deposits ceased only in 2001, which was caused by the rapid fall in nominal interest rates (compared to 1999 by almost half), where real interest rates on deposits, thanks to growing inflation, have since 2000 been reaching even negative values. Owners of deposits in banks are thus effectively losing money, and it may be expected that household deposits will fall, which will under such circumstances advantage consumption, or lead to a search for other options for appreciating savings.

The interest policy of banks in Slovakia represents an



important management instrument which allows them to achieve a high rate of profitability. Currently they earn more from creditors, from whom they obtain undervalued capital resources, rather than on debtors, to whom they provide loans at a relatively low price. The situation will probably change in the future, since following Slovakia's accession to the EU Slovak banks will be exposed to much greater competition than they have to date, and will have to re-assess their interest policy.

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