

A Note on the Spread Between Borrowing and Lending Rates

By Jaime C. Laya

The difference between Philippine bank borrowing and lending rates is usually large, often leading observers to mistaken conclusions.

Borrowers could feel they are being overcharged on their loans, lenders that they are undercompensated for their deposits and policy makers that lending is highly profitable.

The fact is that certain laws and regulations make financial intermediation expensive, specifically:

1. The Central Bank requires that 25% of bank deposit liabilities be set aside, in the form of cash on hand and on deposit with the Central Bank. Reserves held by the Central Bank earn 4% interest.
2. The law requires that 10% of loanable funds be used for lending to agriculture and agrarian reform program beneficiaries or used to purchase certain allowable government securities. Administrative costs, including bad debts, tend to be high for such loans.
3. A Gross Receipts Tax (GRT) of 5% is imposed on gross bank revenues from interest and other income.

The arithmetic is simple. Out of say a P100 deposit, P25 has to be set aside as reserve, leaving P75 for lending, P7.50 will have to be lent for agriculture/agrarian reform purposes. The balance available for unrestricted lending at commercial terms, therefore, is P67.50.

Assuming that the totality of bank reserves earn 4% per annum and agricultural/agrarian reform lending earns 14% per annum, the bank will earn P1.00 on its reserves and P1.05 on agri/agra lending. In effect, it earns P2.05 per annum on P32.50 of the deposit funds originally received. The bank nets P1.9475 after deducting the 5% GRT.

The question, then, is how much should be earned on the remaining P 67.50 for the bank to at least break even. On the basis of the above assumptions, the differences between borrowing and lending rates for the bank merely to break even are as follows:

Table 1. SENSITIVITY OF BREAK EVEN LENDING RATES TO CHANGES IN BORROWING RATES

Borrowing Rate	Lending Rate	B/E Spread
10.00%	12.56%	2.56%
15.00	20.35	5.35
20.00	28.15	8.15
25.00	35.95	10.95
30.00	43.75	13.75
35.00	51.54	16.54
40.00	59.34	19.34

Assumptions: Reserve rate - 25%; earnings on reserves - 4% p.a.; agri-agra lending - 10% of loanable funds; earnings on agri/agra loans - 14%; GRT - 5%.

It is noted that: (a) the breakeven spread widens as borrowing rate rises and (b) the breakeven rate rises by 1.56 percentage points for every one percentage point increase in borrowing rate. Since bank borrowing rates tend to follow Treasury Bill rates, the size of nominal bank spreads likewise tends to vary directly with T-Bill rates.

To earn a profit, then, the bank would have to add its true spread, in the sense of profit margin, to the breakeven lending rate as indicated in Table 1.

For policy making purposes, it is interesting to test the sensitivity of breakeven spreads to changes in reserve requirement, agri/agra requirement, and GRT.

The sensitivity of the spread between borrowing and

Jaime C. Laya is Chairman, Laya Manabat Salgado & Co., CPAs.

breakeven lending rates under alternative levels of Central Bank reserve rates is explored in Table 2. The identical assumptions as earlier described are used, computing breakeven lending rates for various reserve rate levels, of a borrowing rate of 15%.

It is seen that the reduction in reserve rate would have the greatest impact on the breakeven lending rate. At a reserve rate of 25%, breakeven lending rate is 20.35% on borrowing rate of 15%. A 5% reserve rate, however, would mean a breakeven lending rate of 16.68%.

Table 2. SENSITIVITY OF BORROWING AND LENDING SPREAD TO CHANGES IN RESERVE RATE

Reserve Rate	B/E Spread
5.00%	1.68%
10.00	2.44
15.00	3.30
20.00	4.26
25.00	5.36

Note: Borrowing rate - 15%

The sensitivity of the spread between borrowing and breakeven lending rates under alternative levels of GRT is explored in Table 3. The same assumptions adopted earlier are used, computing breakeven lending rates for various GRT rates, of a borrowing rate of 15%.

Table 3. SENSITIVITY OF BORROWING AND LENDING SPREAD TO CHANGES IN GROSS RECEIPTS TAX

GRT Rate	B/E Spread
0%	4.19%
1.00	4.41
2.00	4.64
3.00	4.87
4.00	5.11
5.00	5.35

Note: Borrowing rate - 15%

It is seen that a reduction in GRT would affect breakeven lending rate. At GRT of 5%, breakeven lending rate is 20.35% on borrowing rate of 15%. The elimination of GRT would mean a breakeven lending rate of 19.19%.

The sensitivity of the spread between borrowing and breakeven lending rates under alternative levels of agriculture/ agrarian reform lending is shown in Table 4. The same assumptions adopted earlier are used, computing breakeven lending rates for various agri/agra required lending levels, of a borrowing rate of 15%.

It is seen that a reduction in the agri/agra requirement would affect breakeven lending rate. At agri/agra lending of 10%, breakeven lending rate is 20.35% on borrowing rate of 15%. The elimination of agri/agra lending requirement would mean a breakeven lending rate of 19.72%.

Table 4. SENSITIVITY OF BORROWING AND LENDING SPREAD TO CHANGES IN AGR/AGRA LENDING REQUIREMENT

Agri/Agra Lending	B/E Spread
0%	4.72%
2.00	4.84
4.00	4.96
6.00	5.08
8.00	5.22
10.00	5.35

Note: Borrowing rate - 15%

By way of contrast, breakeven spread is a mere 0.79% if the Central Bank requires non-interest bearing reserves of 5% and if GRT and the agri/agra lending requirement were both eliminated.