



Effectiveness of liberalisation of FC borrowing

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By *Dr. Ahsan H. Mansur*

Effectiveness of liberalisation of foreign currency (FC) borrowing remains an issue in the country. The main reasons for the private sector to seek foreign loan is the interest rate differentials between foreign currency-denominated (international) borrowing and taka-denominated borrowing from domestic banks. Interest rates charged on foreign currency-denominated loans provided to the private sector are generally set in the range Libor plus 3.0%-4.5%, the spread over London inter-bank offered rate or LIBOR (at 3.0%-4.5%) being the combined mark-up charged by the facilitating domestic commercial banks and the counterpart foreign lenders.

The domestic lending rates at present vary between [11%-15%] depending on the customer,

which is very high and is acting as a deterrent for investment and private sector borrowing. In terms of foreign rates, there are two main contributing variables—the LIBOR and the expected movement in the exchange rate between US Dollar and Bangladeshi Taka.

The one-year Libor on October 21, 2014 was 0.55%, and a look at the historical trend for the past few months shows that the rate has been relatively stable. In terms of exchange rate depreciation, during 1990-1999 the decadal annual average change in the exchange was about 4%. The average annual rate of depreciation of the Taka decelerated during 2000-2009 when the decadal average was 3%. The rate of exchange rate depreciation decelerated further during 2009-2014, the five-year average annual rate of depreciation being about 2%.

Despite this enhanced stability of the exchange rate of Taka against the US dollar in recent years, the market and the borrowers however still continue to expect the annual exchange rate depreciation of about 3.0% while making their decisions to go for dollar-denominated loans.

Therefore, considering Libor to be 0.55% and a mark-up of 4.5%, additionally accounting for exchange rate risk factor of about 3%, the cost of borrowing (in taka equivalent terms) from the foreign lenders would be about 8.0% (Mark-up 4.5%+Libor 0.55%+Expectation with respect to exchange rate depreciation of 3%= cost of borrowing 8%).

This rate is still significantly lower than the 11%-14% charged by the domestic banks to domestic prime borrowers. The main reason behind the exchange rate fluctuations is usually the inflation rate differential between Bangladesh and its major trading partners. As we know it very well, domestic inflation rate in Bangladesh is much higher than the inflation rates of its trading partners. Additionally, if borrowers are concerned about the uncertainties associated with the exchange rate depreciation induced increase in cost of fund, they may hedge their risk in the forward foreign exchange market which would give them additional security.

Lower international borrowing rates should stimulate competition within the domestic banking system. In terms of the domestic private sector credit market, liberalisation of access to foreign loans will definitely create pressure on the local banks to reduce their lending rates in order to compete with foreign lenders. Since 2012, there has been a steady decline in private sector growth where private sector credit growth came down to a 13-year

low of 11 per cent at the end of November 2013 and banks' loan-deposit ratio declined to around 71 per cent in December 2013.

While this deceleration has been primarily caused by a slowdown in the economy and a lack of investor confidence due to the political instability in the country, the growing presence of foreign lenders has also been a factor.

The rise in foreign loans inflow has put pressure on local banks to cut their lending rates as entrepreneurs are being attracted to the overseas financiers, said official sources. Borrowing from foreign sources at lower interest rates made the prime entrepreneurs reluctant to take loans at high rates from the country's financial market. It was observed that domestic banks have already started lowering rates on the expectation that the trend will continue further.

As mentioned earlier, the domestic lending rates are already on the decline due to the increased competition from foreign lenders. The deposit rate has also declined from 9.04% to 8.13% from June 2012 to June 2014, which indicates an increase in spread. However, the full benefit of the declining savings rate could not be passed on to the borrowing rate due to the provisioning requirements associated with increased classified loans in the banking system.

The increase in external borrowings by the private sector has added to the swelling of excess liquidity in the country's banking sector. Bankers said the local banking industry is now sitting idle on surplus liquidity - more than BDT 800 billion - because of non-utilization of funds. The credit growth of the banks was 10.29% in March 2013 with BDT 660 billion in excess liquidity. The excess liquidity was BDT 790 billion in June 2013 and in September 2013 as the level of excess liquidity rose further to BDT 840 billion.

Investment activity has been subdued and there has been a fall in lending rates of banks. Domestic banks are also feeling that foreign banks are much well-positioned to take advantage of the situation and have captured this segment of the market. Domestic banks' limited capital base and lack of international network limit their ability to exploit this growing segment of lending business.

BB is expected to ensure that the businesses are aware of the exchange rate risks, and that the funds borrowed from abroad are fully utilised as intended, as there have been allegations

that a section of borrowers deposit the funds in banks at high deposit rates.

The possibility of an exchange rate depreciation is real and must be taken into consideration by the private sector before going for foreign currency-denominated borrowing. It is reassuring that BB is closely monitoring the level of foreign borrowing and the associated repayment schedule. So far the outstanding amount of such loans at more than US\$2.0 billion is manageable and does not pose any significant payments risk.

BB is in a mood to approve foreign loan applications as the policy decision has positive implications on the domestic banking sector such as putting pressure on banks to bring down the lending rates by raising competition. Bankers are now under external pressure to bring down the interest rates on lending due to increased availability of foreign loans. Big entrepreneurs are more interested in taking foreign loans as they can borrow at lower rates which are as low as 6.0%.

However, these entrepreneurs will become interested in taking loans in local currency if the trend of declining lending rate continues and the interest rate in the international capital market move up with the US economy gaining momentum. Domestic lending rates are likely to come down further due to continued cut in deposit rates by the commercial banks and falling inflation.

Borrowing from foreign sources at lower interest rates will also help reduce the interest rate spread in the country's financial market as competition from abroad will push domestic banks for higher efficiency in their banking operations and practices. At the end, Bangladesh's banking sector must start getting integrated with the international capital market and the initiative by BB is to be seen as a small but credible step in that direction.