Economic Review August 2007

The Impact of Credit Screening Rules on Credit Extension by Commercial Banks in Lesotho

The role of credit as a driver of economic growth in an economy cannot be overemphasised. In Lesotho, credit extension is still at low levels. In view of this, the Central bank of Lesotho undertook a study to examine constraints to credit extension in Lesotho…

Background

The exchange between borrowers and lenders in the credit market is not a simultaneous process. The delay involved in repaying the debt exposes the credit transaction to risk. In an attempt to reduce risk, lenders perform three functions, they: i) screen potential borrowers to establish the risk of default; ii) create incentives for borrowers to fulfil their promises; and iii) develop various enforcement actions to make sure that those who are able to repay, do so. Nevertheless, scarcity of information results in information asymmetries between the borrowers and lenders. In order to address the risks that may arise due to lack of information, lenders may attach collateral requirements to the loans.

Like many lenders worldwide, commercial banks in Lesotho also apply credit screening rules to mitigate default risk. When these rules are applied purely to reduce default risk they yield efficiency gains, but they may create market inefficiencies if they end up rejecting borrowers who are willing to take and able to repay the loan amount.

INSIDE

The amount of credit extended by domestic banks is limited, as indicated by the low credit deposit ratio. The pace of credit extension fell short of deposit mobilisation rate in the recent years. Thus the credit deposit ratio responded rather sluggishly from 21.2 percent in 2002 to 32.0 percent in 2006 implying possible existence of tight credit screening rules (see Table 1 below).

Table 1: Credit Deposit Ratio

	2002	2004	2006
Credit Deposit Ratio	21.2	22.7	32.0

The situation of low credit extension prompted the Central Bank of Lesotho to undertake a study to examine commercial banks' credit screening rules and their attendant impact on credit extension in Lesotho. That is to examine factors that influence credit extension in Lesotho.

Commercial Banks' Credit Screening Rules in Lesotho

The credit screening models can be quantitative or qualitative in nature. The pertinent aspects in the risk assessment exercise involve the following factors:

- The borrower's willingness and ability to service and repay the debt.
- A definite source of repayment or acceptable alternative exit strategy.
- A proper understanding of the borrower's business requirement.
- Reputable ownership and management of the business.
- Availability of collateral of adequate value and acceptable quality.
- Sound sustainable financial position and performance, evidenced by audited and current management accounts where appropriate.

In a nutshell, lenders sufficiently review the purpose of the credit and source of repayment; the adequacy of collateral if required; industry trends, and the borrower's capacity to repay based on historical financial trends, cash flow projections and income stream.

Credit Extension in Lesotho: Results of a snapshot undertaking

In order to measure the rate at which commercial banks extend credit, the total number of applications submitted to the banks, excluding applications rejected for not meeting submission requirements, was compared with the number of applications approved for the third quarter of 2005 and 2006. The calculations indicated a year on year improvement. As a share of total approved applications, the number of approvals rose from 97.5 percent in 2005 to 98.6 percent in 2006. Equivalently, this signified an increase of 4.1 percent year on year in 2006. A conclusion that can be reached here is that commercial banks improved their credit allocation for the third quarter of 2005 and 2006 (see Table 2 below).

In 2006, a sample of 3,326 applications was considered for the period July to September. It was observed that 96.7 per cent of these were submitted by households and only 3.3 per cent represented businesses. This could be expected given the higher number of households and the possibility that credit to households may include sole traders. In terms of the rejection rate it was realized that 1.5 per cent of the applications were rejected and 98.6 per cent were approved. Even when looking at the number of applications we may conclude that a negligible amount of applications was rejected.

Table 2: Number of Approved and Rejected Applications

	Type	Approved		Rejected	
		2005	2006	2005	2006
July	**Loans:**	*1009*	*1022*	*25*	*16*
	o/w: Corporate	*14*	16	*5*	3
	Household	995	1006	20	13
	Advances	150	*147*	5	*2*
August	**Loans:**	*874*	*989*	*33*	*18*
	o/w: Corporate	*30*	35	*10*	5
	Household	844	954	23	13
	Advances	100	*90*	5	*2*
September	**Loans:**	*926*	*933*	*12*	*9*
	o/w: Corporate	*50*	47	*4*	2
	Household	876	886	8	7
	Advances	90	*98*	2	*0*
Total		***3149***	***3279***	***82***	***47***

Moreover, rejected applications were analysed to trace the reasons behind such a decision. The findings indicated that a lot of credit applications were turned down due to lack of information, lack of security for the loans, lack of affordability, and high default risk. All these reflected lack of: entrepreneurial capacity, bankable projects, and collateral. Furthermore, it reflected that commercial banks do not compete aggressively for good credit.

Conclusion

As shown at the outset of this article, the credit deposit ratio is quite low in Lesotho. This reflects low credit extension in the economy. However, the findings of the study suggest that a large proportion of loan applications bearing all required documentation (98.6 percent in the third quarter of 2006) are approved. This implied that few applications are submitted to banks possibly due to perceived banks' unwillingness to lend, or a large proportion of loan applications are reject on submission due to inadequate documentation. To investigate these two possibilities, the paper recommended a survey assessing demand for credit by bank customers.

SADC Macroeconomic Convergence and Lesotho's performance

Introduction

SADC countries are pursuing closer integration of their economies with a view to foster stronger economic development. This comes from the realisation that economic cooperation would bring larger economic benefits than when individual countries work on their own.

In August 2002, a Memorandum of Understanding (MOU) on macroeconomic convergence (MEC) initiative was signed by SADC member states. The five years that has passed provide an opportunity to review Lesotho's progress in the attainment of the targets, and the thinking behind macroeconomic convergence as a concept.

Macroeconomic Convergence defined

Macroeconomic convergence can mean many things. McCarthy and du Plessis (2001) divide its meaning into three main ideas: convergence in long-run growth, in business cycles, and in macroeconomic policy.

Long-run growth convergence refers to efforts to encourage or allow lesser developed countries to 'catch-up' with more developed ones by closing the wealth gap over time. The underlying idea is that less developed countries have a potential to grow faster than their more developed counterparts due to presence of more unexploited opportunities and greater potential impact of technological advancement. Measurement methods for catch-up convergence are numerous, including estimation of per capita income gap between countries over time.

Convergence in business cycle refers to the idea that countries entering some form of economic integration should be at similar phases in their business cycles. The focus here is not on 'catch-up' but 'bringing-into-step'. Business cycle convergence between two countries could be achieved through tightening of trade and investment links, or through implementation of anti-cyclical and anti-inflationary policies.

Macroeconomic policy convergence implies harmonisation of policies across countries in terms of design of policies to increase the probability of reaping desired benefits. It does not necessarily imply adoption of similar policies between integrating members, as different levels of growth could call for adoption of different policies to attain maximum benefits at a regional level. Fiscal and monetary policies are some of the strategies that could require harmonisation under a regional integration arrangement.

SADC defines MEC as the convergence by member states to low and stable levels of inflation, sustainable budget deficits, public and publicly guaranteed debt and current account balances. Other economic aspects and political issues are also considered though not defined as strict criteria. SADC MEC targets are specified later in this article.

Why Macroeconomic Convergence is important

Regional integration is seen as an important step in development of individual member countries because free movement of capital, labour and goods and service is believed to raise incomes and eradicate poverty in participating countries than under a restricted system of trade, labour and capital movement. However, successful integration requires MEC given that integrating countries are normally unequal in terms of development and macroeconomic stability. As such, MEC geared towards bringing countries into step in relation of business cycle phases and harmonisation of polices would allow the countries to respond more symmetrically to external shocks. MEC itself could drive the speed of regional integration as it insulates members from adverse effects of opening their economies thereby increasing political will to cooperate.

SADC Integration Schedule and Macroeconomic Convergence Targets

SADC has designed a programme of gradual economic integration starting with the less ambitious options. This programme is as follows;

Free Trade Area (FTA) by 2008
Customs Union by 2010
Common market by 2015
Monetary union by 2016

In line with the integration programme, MEC targets have been defined. These targets get stricter over time to reflect relative complexity as SADC move from one form of integration to the next. The targets are set on four macroeconomic indicators considered vital for successful integration: inflation rate, government deficit, government debt and current account level. Table 3 gives these targets:

Table 3: SADC Macroeconomic Convergence Targets

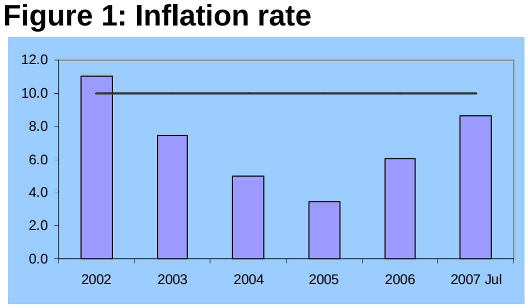
	2008	2012	2018
Annual Inflation rate	1 digit	5%	3%
Fiscal deficit/GDP	<5%	3%	3-1%
Public Debt/GDP	60%	60%	60%
Current account deficit/GDP	-9%	-9%	-3%

Lesotho's performance

In 2002 when SADC introduced the MEC targets, Lesotho's inflation rate was double-digit due to regional drought, depreciating currency due to effects of US World Trade Center attack and high oil prices. However, the inflation rate moved on a downward path in the years that followed (see Figure 1). Introduction of inflation targeting in South Africa; improving agricultural production in the region; and strengthening currency led to a slowdown in inflationary pressures.

A turnaround was experienced after 2005 mainly on account of re-emergence of drought conditions that raised food prices, as well as steep increases in crude oil prices.

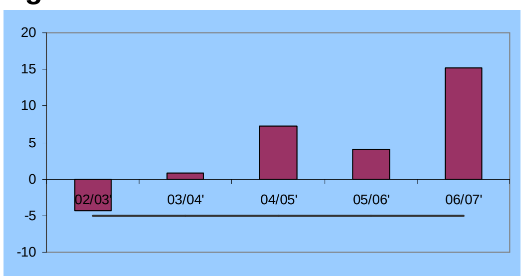
Figure 1: Inflation rate



The drought situation continued to worsen over the years, pushing food inflation to 14.8% in July 2007 and overall inflation rate to 8.6% during the same period. At this rate, inflation is close to the upper limit set by SADC for 2008.

Figure 2 indicates that fiscal balance has been improving over the years, from a deficit close to the 5% limit in 2002/03 fiscal year to a surplus of 15.1% of GDP in 2006/07.

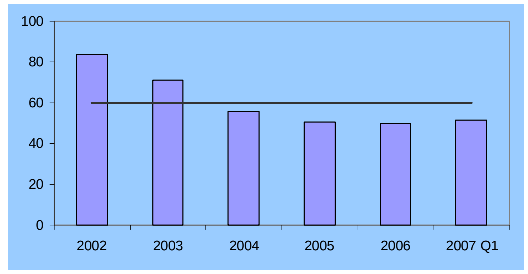
Figure 2: Deficit/GDP



The appreciable improvement was mostly influenced by strong increases in customs revenue from the regional revenue pool, which included backward adjustments. This was coupled with increases in other sources of revenue, both tax and non-tax, as well as relatively slow increases in expenditures. Both customs revenue (the sharing of which is based on import performance of members, amongst other things) and other revenue were influenced by the strong performance in economic activity during the period. The challenge faced by the Government for the future is to find alternative sources of revenue to augment the customs revenue, which might decline over time due to free trade agreements.

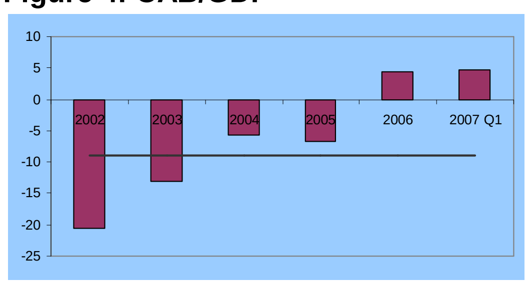
In 2002, total government debt was above the 60% of GDP limit set by SADC for 2008.

Figure 3: Debt/GDP



The high level was mostly influenced by the effect of a weak currency on external debt. However, debt has been declining in local currency terms as the loti appreciates over time. The loti strengthened from an annual average of M10.41 per US dollar in 2002 to M6.78 in 2006. In addition to the currency effect, the government has gradually been repaying part of the debt, especially commercial loans. At the end of the first quarter of 2007, the debt to GDP ratio stood at 51.6% (see Figure 3).

Figure 4: CAB/GDP



The Current account balance (CAB) improved from a deficit of 20.6% of GDP in 2002 to a surplus of 4.6% in the first quarter of 2007. The deficit was influenced by large increases in imports due to high government capital expenditure, high cereal imports and generally strong consumer demand. The strong performance in the recent years is accounted for by SACU receipts, as mentioned earlier, and favourable performance of manufacturing sector's exports.

Conclusion

Lesotho has performed well against core MEC targets of SADC in the period 2002 to date. It is clear that a forward looking strategy and consideration of business cycle effects in managing performance is helpful, given drastic changes in the trend of these variables that occur within a few years as demonstrated by inflation rate during the period reviewed. The behaviour of the inflation rate in the coming years will be influenced by developments in food and oil prices. Exchange rate movements, changes in SACU revenue as new trade agreements are signed and government's ability to raise alternative sources of income will determine the behaviour of the deficit, CAB and possibly public debt.

Monetary Policy Operations for August 2007

Central Bank of Lesotho employs monetary policy as a vital instrument to achieve price stability using open market operations (OMO). This enables the Bank to maintain money market rates that are in line with the South African counterpart rates, and realise the ideal level of Net International Reserves (NIR) to defend the parity between the local currency, Loti, and the South African Rand.

Although the Lesotho 91-day treasury bill rate continued to increase in August, it was still below its SA counterpart rate. The Lesotho 91-day treasury bill rate increased by 14 basis points to 7.76 per cent whereas the SA counterpart declined from its previous level of 9.10 per cent in July to 8.86 per cent in August. Consequently, the margin between the two rates narrowed from 148 basis points to 110 basis points at the end of the review period, as depicted in Figure 5 below.

Figure 5. Measuring the Success of Monetary Policy Objectives: Lesotho 91-Day T-Bills vs RSA T-Bills

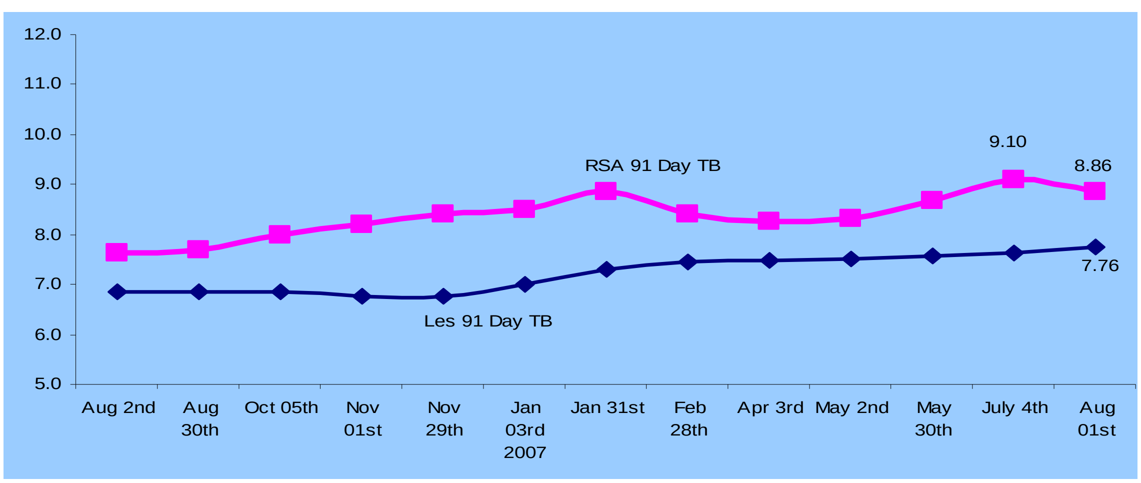


Table 4: Selected Monetary and Financial Indicators

	2007		
	May	***June***	***July***
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	*13.67*	*14.08*	*14.08*
1.2 Prime Lending rate in RSA	*12.50*	*12.50*	*13.00*
1.3 Savings Deposit Rate	*3.01*	*3.21*	*3.21*
1.4 Interest rate Margin(1.1 – 1.3)	*10.66*	*10.87*	*10.87*
1.5 Treasury Bill Yield (91-day)	*7.50*	*7.56*	*8.64*
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	*3621.9*	*3788.4*	*3591.21*
2.2 Net Claims on Government by the Banking System	*-2710.1*	*-2420.4*	*-3544.02*
2.3 Net Foreign Assets – Banking System	*7477.1*	*6965.2*	*8126.46*
2.4 CBL Net Foreign Assets	*5680.8*	*5233.7*	*7039.86*
2.5 Domestic Credit	*-1673.2*	*-1312.2*	*-2402.50*
2.6 Reserve Money	*470.42*	*585.6*	*489.37*
3. Spot Loti/US$ Exchange Rate (Monthly Average)	***7.0142***	***7.1622***	***7.1205***
4. Inflation Rate (Annual Percentage Changes)	***7.6***	***8.0***	***8.6***
5. External Sector (Million Maloti)	***2006***		***2007***
	QIV	***QI***	***QII***
5.1 Current Account Balance	*18.50*	*697.20*	*1.68*
5.2 Capital and Financial Account Balance	*-81.15*	*190.60*	*202.63*
5.3 Reserves Assets	*-32.81*	*-1023.89*	*143.38*

+These indicators refer to the end of period. Prime and deposit (savings) rates are averages of all commercial banks' rates operating in Lesotho. The Statutory Liquidity Ratio in Lesotho is 25 percent of commercial banks' short-term liabilities

Table 5: Selected Economic Indicators

	2004	***2005***	***2006***	***2007+***
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	*4.2*	*2.9*	*7.2*	*4.9*
1.2 Gross National Product – GNI	*7.9*	*5.5*	*3.1*	*3.6*
1.3 Per capita –GNI	*7.9*	*5.5*	*3.1*	*3.6*
2. Sectoral Growth Rates				
2.1 Agriculture	*-1.9*	*-1.7*	*1.7*	*-22.5*
2.2 Manufacturing	*2.1*	*-8.6*	*10.5*	*11.0*
2.3 Construction	*-4.4*	*-3.4*	*0.6*	*2.5*
2.4 Services	*2.1*	*4.1*	*6.6*	*6.3*
3. External Sector – Percent of GNI				
3.1 Imports of Goods	*86.3*	*83.1*	*80.1*	*86.5*
3.2 Current Account	*-4.7*	*-5.7*	*3.5*	*8.6*
3.3 Capital and Financial Account	*5.8*	*3.6*	*-1.2*	*5.9*
3.4 Official Reserves (Months of Imports)	*5.2*	*5.5*	*6.7*	*7.2*
4. Government Budget Balance (Percent of GDP)	*5.7*	*4.8*	*12.6*	*4.8*

** Preliminary estimates*
+CBL Projections