By capital editor
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The National Bank of Ethiopia (NBE), the regulatory body of financial institutions in the country, issued two new directives on commercial banks this past week, setting the minimum requirement for short term loans at 40 percent of the bank's total loan provision. It also cut commercial banks' total deposit reserve requirement down to five percent, from the previous 10 percent.

Even though private bank operators welcome the reserve requirement reduction of five percent, they still raised concern on the constraint that forces them to set aside 40 percent of their loans for short term loans.

The NBE directive is to be effective as of the coming new Ethiopian budget year that starts from July 2013. The central bank has also given the banks until January 2015 to restructure their loan portfolios to the stated ratio. "The new directive is supposed to push commercial banks to purchase more NBE bills worth 27 percent of the loans disbursed," said one banker on conditions of anonymity. "This directive however will limit the flexibility of the banks." "Setting aside 10 percent of total loans to revolving loans disbursed to pre-shipments, merchandise, and over draft facilities, we will only be able to mobilize 50 percent of our total capacity to midterm and long term loans," the banker explained.

The 27 percent NBE bill purchase requirement has a tangible impact on the banking sector, including maturity mismatch and less profitability, as private banks collect savings at two to three-year maturity, even shorter in some cases, but have to freeze these resources for five years at rates lower than the cost of funds, according to the International Monetary Fund (IMF) report released in October 2012.

"The requirement on private banks to purchase NBE bills equivalent to 27 percent of any new loans appears to have a sizable negative impact on private banks' intermediation activities," says the report.

Meanwhile, a veteran banker Capital talked to said slashing down the deposit reserve requirement to five percent, from the previous 10 percent will increase the capacity of commercial banks' loan performance. "However, it will also increase the amount of NBE bills purchased, and in the long run, it will harm the capacity of especially private banks that are already weak financially compared to state-owned banks," the banker added.

This is the second time in two years the NBE reduced the requirement in deposit reserves from 15 percent three years ago to 10 percent last year and now to 5 percent.

Meanwhile, the central bank this time will not inject the five percent deposit back to the respective banks according to their reserve, for fear of rising inflation.

"As the central bank is concerned about inflation it will not reimburse the money commercial banks deposited until now. Instead the funds will remain with NBE but now with interest counting," another banker said.

NBE's directive states that short term loans will mature in a year's time but commercial banks traditionally go up to three years for short term loans.

The IMF report also criticizes the requirement of the NBE bills purchase saying that private banks will be forced to increase service charges on the private sector as the requirement will significantly reduce their profitability. "There is also a risk that the profitability of private banks reduces on account of less intermediation because of the directive. As a result, private banks could raise non-interest income charges such as fees and commissions to recoup these losses, further impacting negatively on the private sector," adds the report.

The IMF cautioned in its report that the 27 percent bill requirement has the potential of crowding out private sector financing.