Commercial Banks' Interest Rates Behaviour in Bangladesh: A Critical Analysis

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Abstract

Commercial bank's interest rates (lending rates) behavior has become major issue in Bangladesh. It is influenced by factors, such as-reserve requirements, policy rates of Bangladesh Bank, deposit rates, CPI, NSD certificate rates, banks' expenditure income ratio, profitability, liquidity, solvency, monetary and fiscal policy stances, and non-economic factors. In recent times, private sector credit growth was lower than the expected growth mainly due to investors less consciousess and their go slow strategy in the backdrop of political uncertainly. An attempt has been made to analyze the factors influencing lending rate behavior in Bangladesh using Ordinary Least Square Method (OLS). It is found that CPI, excess reserve, deposit rate and policy rate significantly affect interest rates (lending rates) behavior of commercial banks. However, it is commonly believed that NPL is the most crucial factor that forces banks to fix high lending rates. But in our study we have found that NPL is not statistically significant. In the perspective of existing higher lending rate, it is necessary to take systematic efforts to put in place a reasonable interest rate structure in a ustainable manner taking socio-economic realities into consideration.

Section 1: Introduction

Commercial banks' interest rates (lending rates) behavior has become a major issue in recent years considering its importance in economic growth and development of the country. In this context, banks should have the potential, scope and prospects for mobilizing financial resources and allocating them to productive investments efficiently. Commercial banks' lending rates behavior is influenced by so many factors such as policy rates of central bank, reserve requirements, deposit rates, profitability, liquidity, solvency, investment climate, fiscal and monetary policy stances. The regulatory requirements may impinge on banks' balance sheet and thus, influence their optimal lending rate response to the policy interest rate (Dhal,2010). It is observed that commercial banks in a country generally adjust their lending rates in tandem with the central banks' policy rates for an effective transmission of monetary policy through the interest rate channel. In contrast to the traditional interest rate channel, the banks focus on two necessary conditions for the existence of the bank lending channel-ability of monetary policy to affect the bank loan supply and the dependency of borrowers on bank loans. Besides, the lending behavior is also affected by political influences, especially for the state-owned banks. In full compliance with the stipulated regulations, the banks resort to prudential guidelines to

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avoid failures and to enhance efficiencies in their lending activities especially by maximizing their profit.

The banking sector of Bangladesh comprises of four categories of scheduled banks: 4 state-owned commercial banks, 39 private commercial banks (PCBs), including 7 Islamic banks, 4 development financial institutions (DFIs) and 9 foreign commercial banks (FCBs). Since FSRP in 1996, the banking sector of Bangladesh has been undergoing gradual transition processes which have impacts on banks in fixing deposit and lending rates. Bank's lending rates in Bangladesh are said to be higher and do not create favorable environment for the growth of private sector credit and, investment demand and hence retard economic growth. It is observed that there is an existence of comparatively high interest rate spread (IRS) in the banking sector of Bangladesh which raises concern among the policymakers and the business community with the apprehension that high IRS impedes private investment which indicates the inefficiencies in the banking system. In other words, it can be said that high IRS means low deposit rates which discourages savings and reduces the availability of loanable funds. The persistence of non-performing loans is one of the major problems of the banking sector in Bangladesh which is viewed as an obverse mirror image of the ailing banking industry.

The main objectives of the paper are a) to analyze the interest rates (lending rates) behavior of commercial banks in Bangladesh; b) to examine the factors that influence the lending rates behavior; and c) to identify the causative factors responsible for lower private sector credit growth in Bangladesh in recent times.

This research paper is divided into seven sections. Section 1 gives introduction while section 2 provides literatures on previous studies related to the research topic. An overview of lending rates behavior in Bangladesh is discussed in section 3. Section 4 presents current status of interest rate in Bangladesh. Methodology of the research is presented on section 5. Section 6 discusses estimation results. The last section draws concluding remarks.

Section 2: Literature Review

A lot of studies have been done in the area of interest rates (lending rates) behavior of banks due to its importance and the issues surrounding it. According to Adedoyin and Sobodun(1996), " lending is undoubtedly the heart of banking business. Therefore, it's administration requires considerable skill and dexterity on the part of bank management."

Commercial banks' behavior in setting their deposits and lending rates significantly influences effectiveness of monetary authority in its policy making. Banks may set their lending rates as some mark up or premium over the deposit rates. If the premium is perceived to be too high or too low, the market force will compell banks to adjust back to some equilibrium spread (Thompson, 2006)

According to Benkovskis, (2008)" a change in policy–induced interest rates influences the real economy by affecting various relative prices. A higher cost of capital increases the returns required for an investment project and therefore, diminishes investment expenditures. Changes in interest rates also affect consumption, as higher interest rates decrease the price of future consumption. However the interest channel theory ignores some important processes in the banking sector. The existence of the bank lending channel has a very important implication for monetary policy: the transmission process of monetary policy depends on the structure of the financial system. This means that structural changes in financial era may affect monetary transmission

A.K. Kashyap and J. C. Stain (1995) argue that the effect of monetary policy on the bank loan supply depends on the regulatory framework, as risk-based capital requirements can tie a banks' ability to extend loans to it's level of equity capital and constrain lending. The speed of monetary transmission depends on bank loan maturity and interest rate type. The bigger the share of short-term loans with a floating interest rate, the faster the response of loan supply to changes in monetary policy will be.

The interest rate spread is one of the important determinants of the banking system's efficiency. According to Mujeri & Younus (2009) " the IRS reflects the cost of intermediation activities including the operating costs and liquidity risks that the banks bear in linking the savers and investors". In addition, banks in Bangladesh incur several other costs which are relatively high, such as cost of non-performing loans (NPLs), administrative & incidental costs including expenses that the banks incur in setting up new branches, attracting & retaining skill personnel, advertising, and other expenditures that the banks undertake to increase market share & business. Regarding higher lending-deposit rate spread in Bangladesh's banking sector, Farasuddin (2005), Mujeri & Islam (2008) are of the opinion that high interest rate spread is largely the outcome of inefficiencies & lack of competition in the banking system. The factors that contribute to the persistence of high IRS, it is important to focus on variables which influence the decisions of the banks regarding the levels at which the deposit and lending rates would be set. In practice, such factors could cover elements which are both internal & external to the banking sector. Within the market determined interest rate policy regime, tools available to Bangladesh Bank for influencing the interest rate structure is somewhat limited in number so that it would be useful to urge the banks as well as to become more aware of and responsive to their corporate social responsibility .Moreover, a more coordinated use of fiscal policy is essential so that the burden of reducing the IRS does not fall on monetary measures alone.

BB's recent Study(2014) on "Lending Rates Behavior in Bangladesh: Some facts and Determinants", shows that bank deposit rates i.e. cost of fund is one of the main determining factors that affects lending rate of banks in Bangladesh. It is found from the study that if deposit rates increased by 100 basis points SCBs and FCBs will adjust lending rates by more than 100 basis points (by 135 basis points and150 basis points respectively).

While for FCBs and SPBs, 100 basis points increase in deposit rates will increase lending rates by 85 and 63 points respectively. Both 3 year and 5 year NSD certificate rates affect the lending rates for all groups of banks except for FCBs. The lending rates increase by 24, 28 & 17 basis points respectively for 100 points increase in the 3 year NSD certificates rates for SCBs, PCBs and SPBs. Only FCBs consider repo and reverse repo policy rates while determine the lending rates by 34 basis points due to 100 basis points increase in the lending rate. It is suggested in the study report that the threshold level of the lending rates lies within the range of 11.5-12.0 percent above which the private sector credit growth of Bangladesh may be adversely affected. A minimum level of weighted average deposits rate of 5.6 to 5.7 percent is also suggested in this study and after that level an increase in the deposit rate will increase the lending rate.

A seminar paper (presented by the BB study group, June 2014) titled 'A Comparative Analysis of Interest Rate Spread in the Banking System" has pointed out that the higher lending rate and the lower deposit rate offered by some PCBs and FCBs led to a high spread in the banking system of Bangladesh. It is suggested in this seminar paper that WAIS method excluding SME is the best method for monitoring IRS on monthly basis as this method measures intermediation costs which better reflects comparison of intrinsic bank efficiency.

Regarding the lending rates behavior, a presentation titled "An Analysis of Recent Slow-moving Credit Flows" by BRPD, BB (10 July 2014) has drawn attention to the fact that in recent times, borrowers and investors seemed not to be confident enough on overall investment climate which led to lower demand for credit. Besides, banks are over cautious and hesitate to persuade fresh lending and availability of cheaper foreign fund lessened credit demand further. All these factors ultimately resulted in slow-moving economic activities as pointed out in the presentation of BRPD.

A preliminary findings of a BB Survey Report on Loan against Trust Receipt (LTR, June, 2014) has pointed out that there is a tendency of banks to convert the LTR into term loan by exercising malpractices of LTR facility in their lending behavior which have a negative effect in the banking system.

Section 3: An Overview of the Interest Rates Behavior in Bangladesh

Bangladesh had a comprehensive system of controls on the level and structure of interest rates until 1990. The administered nominal rate structure was changed infrequently with changes in inflation. While deposit rates during the period 1985-90 were relatively very high in real terms, nonetheless, the relationship between deposit & lending rates and the complexity & rigidity of administered interest rates undermined the role of interest rates in mobilizing savings to meet investment demand & in allocating investible resources efficiently among competing users. Under the administered interest rate regime, Government clearly attempted to provide positive incentive to savers and at the same time attempted to keep lending rates low in order to keep investment cost low. An important effect of this potentially conflicting policy objective had been to squeeze commercial banks' margin and reduce their incentives to mobilize deposits. In view of the disadvantages of this policy, BB moved to a market-oriented approach to interest rate determination with deposit rates that better reflect market forces & lending rates that influence cost of funds and intermediation costs & risks. With liberalization towards a market-oriented interest policy under the FSRP which became effective in January 1991, banks are allowed to set lending & deposit rates within bands set by BB. All deposit rates were decontrolled except for DPS and some special rates for short-term deposits. On the other hand lending rates are all freely determined by the market except for agriculture, small industry and exports. Subsequently, the bands are removed allowing the banks to set interest rates independently with effect from February 19, 1997. Further flexibility in the interest rate policy was introduced from July 12, 1999 permitting banks to differentiate interest rates to individual borrowers except for lending to exporters only. Apart from the conventional deposit and lending rates, the Islamic banks in Bangladesh have been carrying on their banking transactions in line with the Islamic shariah systems of interest-free policy. Under this policy, modes of investment of the bank are done through bai-murabaha,bai-muajjal' hire purchase under shirkatul melk, mudaraba, musharaka, bai-salam, bai-as-sarfs according to a pre-agreed profit sharing ratio to ensure a reasonably fair rate of return.. It has been observed that despite liberalization, interest rates are not fully responsive to market conditions because of several rigidities in the banking system, including directed lending to priority sectors and to state-owned enterprises. In this perspective, the current decade witnessed some major policy shift as BB introduced Repo in July 2002 and Reverse repo in April 2003 and reintroduced Bangladesh Bank Bill in 2006 as policy instruments for influencing financial sector.

BB introduced the risk-based capital adequacy framework for banks from January 2010 as a regulatory compliance with a view to ensuring that banks are accurately assessing all material risks they are exposed to & maintaining the required capital commensurate with their risk profile. Banks are required to maintain the capital adequacy ratio at greater than or equal to 10 percent of risk- weighted assets. Meanwhile, BB has declared the Roadmap and Action Plan of the phase in arrangements for Basel-III.

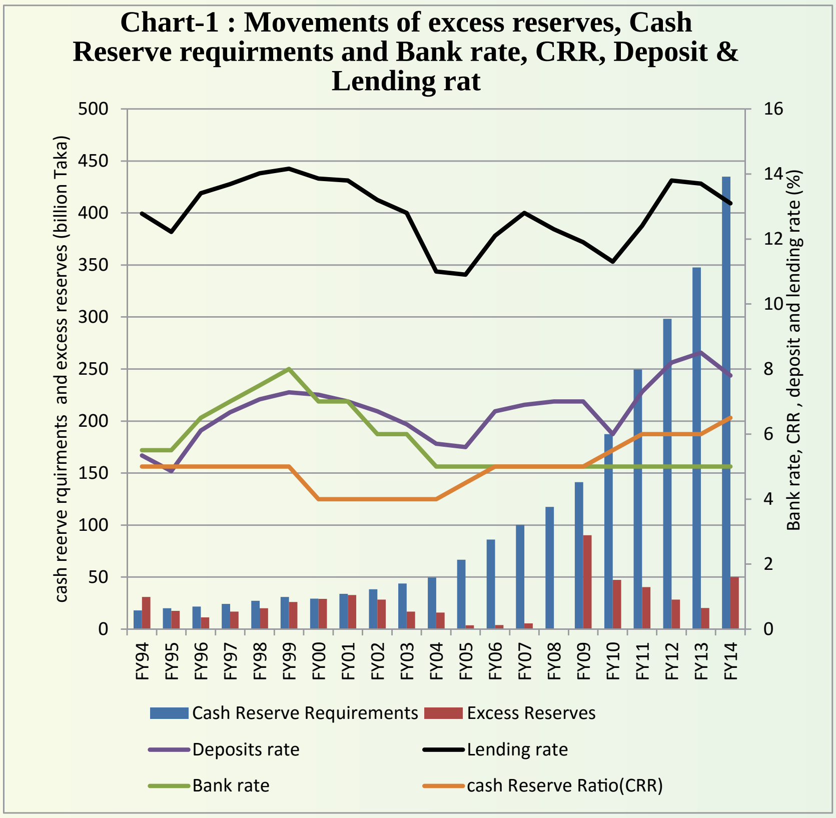
Near the end of FY13, BB changed its policies on loan classification and loan-loss provisions. It has been observed that the SCBs and DFIs continue to have high level of NPLs mainly due to substantial loans provided by them on considerations other than commercial criteria. Poor appraisal and inadequate follow-up and supervision of the loans disbursed by the SCBs and DFIs in the past eventually resulted in these poor quality assets. Furthermore, these banks were reluctant to write-off the historically accumulated bad loans because of poor quality of underlying collaterals. Recovery of NPLs, however, has witnessed some signs of improvement, mainly because of the steps taken with regard to internal restructuring of these banks to strengthen their loan recovery mechanism and recovery drive and write-off measures initiated in recent years. In FY 13, due to BB's temporary relaxation in the loan scheduling standard, the amount of rescheduling loans skyrocketed.

It has been observed that undue political influences on state-owned banks in Bangladesh are very strong than that of the private banks. These banks are very much sensitive to the decision of the government and disburse loan to many politically connected individuals, enterprises, or even to prominent political figures which ultimately turns into non-performing loans to a greater extent.

Section 4: Current Status of Interest Rates

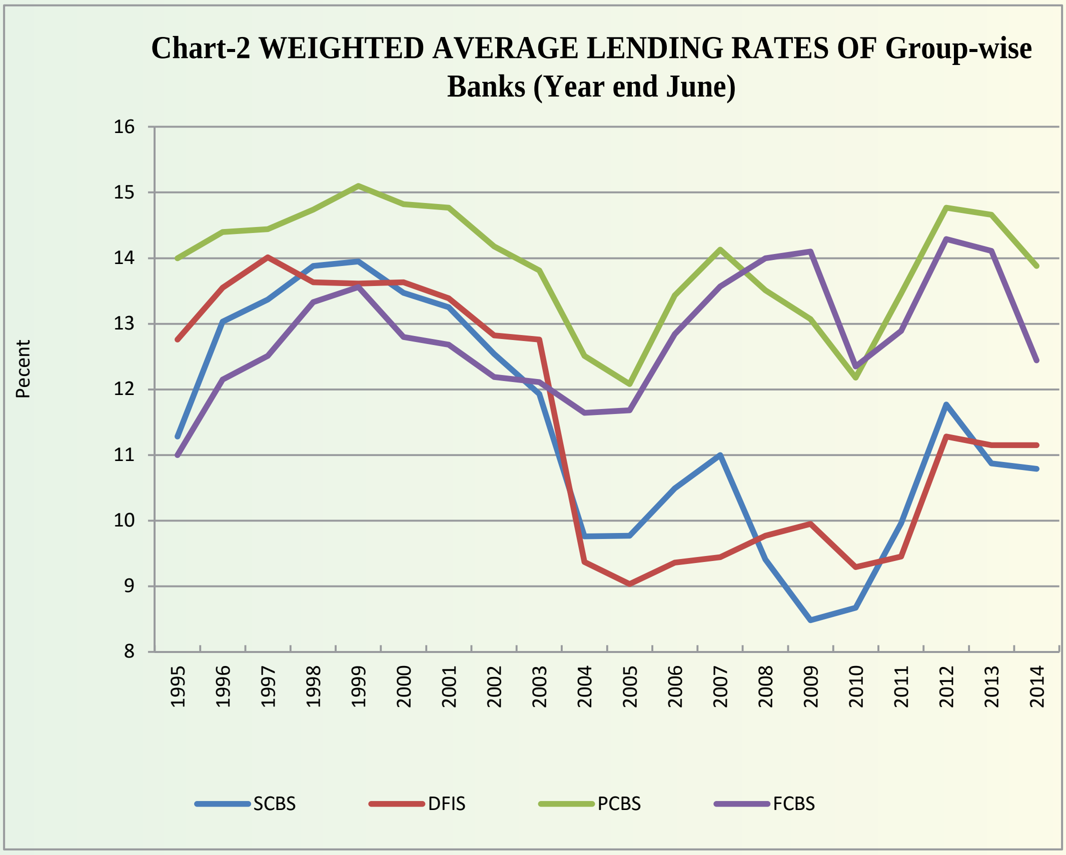
The weighted average lending rate declined to 13.10 percent in FY14 from 13.67 percent in FY13. The deposit rate also declined to 7.8 percent in FY14 compared to 8.5 percent in the preceding year. The large excess liquidity in the banking system resulted in lowering the deposit rate. The trends of the spreads between lending and deposits rates were above 5 percent from FY10 to FY14. The interest rate spread (nominal) was stood at 5.31 percent in FY14 compared to 5.13 percent in the preceding year where the real spread was -1.99 percent during the same period (Chart-1). The weighted average lending rate of banks declined to 12.8 percent at the end of August from 13.6 percent a year earlier. In addition to lower private credit demand, higher competition among banks contributed to the decline in the lending rate. The deposit rate also declined to7.6 percent from 8.6 percent, remaining positive in real terms as it was still higher than inflation. The large excess liquidity in the banking system contributed to the lower deposit rate. The interest spread of the banking system widened marginally to 5.1 percentage points from 5.0 in August 2013. Due to slower private credit growth, liquidity in the banking system remained high despite the cautious monetary stance and significant sterilization operations conducted by BB. Excess liquidity in the banking system stood higher at TK. 1.5 trillion at the end of August 2014 compared to TK.823.2 billion a year earlier.

The foreign borrowing during the last couple of years was too small compared to the domestic borrowing by the entrepreneurs from the local banks. But regarding lending rates, they are not at all competitive as compared with interest on lending by their foreign counterparts. Because of higher cost of fund, the local banks would not be able to offer such low interest rate which creating threats to the domestic banks as some banks with high lending rates may face the problem of excess liquidity if foreign sources of borrowing become gradually available to all potential investors. It has been observed that lending rates of local banks are around 12-15 percent while for foreign borrowing the rate is 3-4 percent plus LIBOR. As the interest rates offered by local banks on term deposits are much higher than the rates on external borrowing, this may encourage some borrowers to deposit funds in the local banks borrowed from outside to earn some easy profit.



The weighted average lending rate of SCBs, DFIs, PCBs and FCBs were 10.79, 11.15, 13.88 and 12.44 percent respectively in FY14 where deposit rates were 7.19, 9.47,7.94 & 4.52 percent respectively compared to SCBs, DFIs, PCBs and FCBs the preceding year. The nominal interest rate spreads were 3.10, 1.68, 5.94 & 7.92 respectively for SCBs, DFIs, PCBs and FCBs during the same period (Chart-2).

It is mentioned in the Monetary Policy Statement (MPS) of BB (January-June 2015) that Bangladesh Bank will endeavour to reduce the existing spread of 5.2 percent between lending and deposit rate so that the lending rate can be pulled down to incentivize the investors. The business community views the existing average lending rate of 12.5 percent as high enough to dampen investment vigour. However, reducing interest rates will bring inflation down further. Otherwise real deposit rates will be negative, discouraging domestic savings and making investment finance inadequate. Bangladesh Bank urges the commercial banks to device ways to reduce the lending rates which did not come down along with inflation correspondingly. The MPS has also drawn attention to the fact that inflation dropped by almost 5 percent age points since the end of 2011, but the average lending rate dropped by only 1 percentage point since then, empowering the banks to earn higher real rates of interest and thus making investment more expensive than before.



It is opined by many that NPL is the most crucial factor that forces banks to fix high lending rates and high nominal spreads in order to recover past loan losses. It has been observed that the ratio of NPL to total loans of all the banks had shown an overall declining trend from its peak (34.9 percent)in 2000 up to 2011 before it increased to 10.0 percent in December 2012. The ratio further increased to 10.8 percent at the end of June 2014. The rise in the gross NPL ratio has been attributed in part to the high NPL of the SCBs and the DFIs, and also due to the reasons of issuance of the circular regarding new classification and rescheduling of loans and a few notable scams in the banking industry. The SCBs and DFIs continue to have high level of NPLs mainly due to substantial loans provided by them on considerations other than commercial criteria. Furthermore, these banks were reluctant to write-off the historically accumulated bad loans because of poor quality of underlying collaterals. The NPLs for PCBs & FCBs are significantly lower than SCBs. Though the macroeconomic indicators showed better performances in FY 14 but the banking sector's classified loan increased steadily during the year .It's a matter of concern that the banks' capital adequacy ratios are shrinking with the rising bad loans when implementation of the BASEL-III is under process.

Regarding policy rates, the rate of interest for repo, special repo and LSF remained unchanged at 7.25 percent, 10.25 and 7.25 percent respectively for 1-2 day tenor till to date. On the other hand, interest rate against reverse repo remained unchanged at 5.25 percent during the same period. Bank rate remained unchanged at 5.00 percent which has been in effect since 6 November 2003.

The Cash Reserve Requirement for the scheduled banks with the Bangladesh Bank has been increased by 50 basis points to 6.50 percent of their total demand and time liabilities with effect from 24 June 2014. The statutory liquidity ratio(SLR) for the conventional banks shall not be less than 13.0 percent of their total demand and time liabilities, and for the shariah based Islami banks, this rate shall not be less than 5.5 percent. This has been in effect from 1 February 2014.

Private sector credit growth during FY14 was 12.3 percent which was lower than the programmed growth of 16.5 percent mainly due to investors had been a bit conscious and followed a go slow strategy in the backdrop of political uncertainty, cautious lending practices by banks following scams in few banks, strong supervision activities by BB and facilitation of private sector trade credit from abroad.

Section 5: Methodology and Sources of Data

5.1. Sources of Data

Data used in this paper is secondary in nature and are taken from various issues of Annul Report and Monthly Economic Trends of Bangladesh Bank. Data duration is 1994-2014.

5.2. Formulation of Empirical Model

The model is specified implicitly below:

$$LENR = f\,(CPI,\ CRRQ,\ NPL,\ EXP\_INCOME\_RATIO,\ RETURN\_ASSET,\ EXCESS\_RESERVE,\ DEP\_RATE,\ NSD\_CERTI,\ GDP,\ POLR,\ Z) \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (1)$$

Where Z contains other variables not explicitly included in the model. The explicit form of equation (1) is:

$$LNR=\alpha 0+\alpha_1 CPI+\alpha_2 CRRQ+\alpha_3 NPL+\alpha_4 EXP\_INCOME\_RATIO+\alpha_5 RETURN\_ASSET + \alpha_6\ EXCESS\_RESERVE+\alpha_7\ DEP\_RATE +\alpha_8\ NSD\_CERTI +\alpha_9\ GDP +\alpha_{10}\ POLR +\mu$$

Where,

LNR = Lending Rate
CPI = Consumer Price Index

CRRQ = Cash Reserve Requirements
NPL = Ratio of Net Non-Performing Loan to Total Loans
EXP_INCOME_RATIO = Expenditure Income Ratio
RETURN_ASSET= Return on Assets
EXCESS_RESERVE = Excess Reserve
DEP_RATE = Deposit Rate
NSD_CERTI= National Savings Certificate
GDP = Gross Domestic Product
POLR = Policy Rate
Error Term

Section 6: Estimation Results and Analysis

According to Gujarati (2004), most macroeconomic time series are not stationary at levels. This implies that most ordinary least squares (OLS) regressions that are carried out at levels may not be reliable. Giving this knowledge, testing for stationary of variables to obtain a more reliable result becomes very essential. This research paper carried out stationary test of the variables using Augmented Dickey-Fuller (ADF). First, unit roots for all variables at levels are tested. It is found that all the variables contain unit roots at levels. However, when first difference is used, it is found that variables used in the research are stationary (Table 1).

Table 1: Unit Root Test and First Difference Test of Variables

Variables	Level	First Difference
LNR	I(0)	I(1)***
CPI	I(0)	I(1)***
CRRQ	I(0)	I(1)***
NPL	I(0)	I(1)***
EXP_INCOME_RATIO	I(0)	I(1)***
RETURN_ASSET	I(0)	I(1)***
EXCESS_RESERVE	I(0)	I(1)***
DEP_RATE	I(0)	I(1)***
NSD_CERTI	I(0)	I(1)***
GDP	I(0)	I(1)***
POLR	I(0)	I(1)***

Estimation results of the research paper are presented in Table 2.

Table 2: Estimation Results

Dependent variable: Lending Rate; Number of observations=17; F(10,6)=11.34; Prob>F=0.0038, R-squared =0.9497; Adjusted R-Squared=0.8660; Root MSE: 0.29246				
	Co-efficient	**Std.Err**	**t**	**p>|t|**
CPI	-0.11**	0.04	-2.61	0.04
CRRQ	-0.00	0.00	-0.66	0.53
NPL	0.07***	0.03	1.93	0.10
EXP_INCOME_RATIO	-0.08***	0.04	-2.08	0.08
RETURN_ASSET	-0.73	0.39	-1.88	0.11
EXCESS_RESERVE	-0.02**	0.00	-2.81	0.03
DEP_RATE	0.97*	0.18	5.50	0.00
NSD_CERTI	-0.06	0.10	-0.61	0.56
GDP	-0.06	0.18	0.37	0.73
POLR	0.15**	0.07	2.40	0.05

Note: * Significant at 1% confidence interval; ** Significant at 5% confidence interval; ***

Significant at 10% confidence interval

From the estimation results, it is found that CPI, excess reserve, deposit rate and policy rate significantly affect lending rate behavior of banks. Deposit rate is positively correlated with banks' lending rates behavior and a change in deposit rate will yield higher change in banks' lending rate. Increase in the deposit rate also results in the increase in the cost of funds of the banks, therefore, in order to minimize the cost of funds of the banks, banks raise interest rate. Policy rate is also found positively correlated with banks' lending rate which implies that monetary policy significantly affect on banks' lending rate. If policy rate increases then it increases the lending rate which has also incidence on money market rate. It is found that CPI and excess reserve are negatively correlated with lending rate behavior of banks. Depressed investment scenario and business largely contribute the low demand for funds from banks. Variables such as cash reserve requirements, non-performing loan, expenditure income ratio, return on assets, excess reserve, national saving certificate and gross domestic product does not have significant relationship with lending rate. This may be because of other non-economic factors like corruption, political influence, political uncertainty and over cautious lending practices by banks.

Section 7: Concluding Remarks

Commercial banks interest rates (lending rates) behavior has become a major issue in recent years. Commercial banks' lending behavior is influenced by many factors such as interest rate, deposits, investments, profitability, liquidity, solvency and monetary policy stances. It is commonly believed that NPL is the most crucial factor that forces banks to fix high lending rates and high nominal spreads in order to recover past loan losses. But in our study we have found that NPL is not statistically significant. This may be because of non economic factors are influencing banks lending behavior. The SCBs and DFIs continue to have high level of NPLs mainly due to substantial loans provided by them on considerations other than commercial criteria. It has been observed that undue political influences on state-owned banks in Bangladesh are very strong than that of the private banks where state-owned banks disburse loan to many politically connected individuals, enterprises, or even to prominent political figures which ultimately turns into non-performing loans to a great extent. Recently, there has been a tendency of some banks to convert the LTR into term loan by exercising malpractices of LTR facility in their lending behavior. In the recent times, private sector credit growth was lower than the expected growth mainly due to investors has been a bit conscious and followed a go slow strategy in the backdrop of political uncertainty, overcautious lending practices by banks following scams in few banks, strong supervision activities by BB and facilitation of private sector trade credit from abroad. Commercial banks should adjust their lending rates keeping harmony with BB's policy rates for an effective transmission of monetary policy through the interest rate channel. It is felt that banks should cut interest rate on loans with a view to creating an investment- friendly environment in the country. Besides, there is a need to take systematic efforts to set a reasonable interest rate structure in the banking sector in a sustainable manner considering socio-economic realities of the country.

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