Policy Note: PN 2021-08

Recent Behavior of Lending and Deposit Interest Rates in the Banking System of Bangladesh

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December 2021

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Bangladesh Bank

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Abstract

This policy note reviews the recent behavior of lending and deposits interest rates by the type of banks in Bangladesh. The note also attempts to address whether the capped lending rate or floor deposit rate (on the term deposit) has caused any distortion in the banking sector. The note concludes that since the current weighted average market lending rate is much lower than the cap, which indicates that the cap seemingly does not create any distortion in the lending rate. Rather, market forces are the main factors for recent interest rates in the banking system. The note also finds that, in case of fixed deposits, banks still pay higher rates than the prevailing inflation rates.

I. Introduction

Shortly after the liberation of Bangladesh in 1971, the Bangladesh Bank (BB) had introduced a controlled interest rate policy, setting both deposit and lending rates for commercial banks which continued before the end of 1990s. The BB, in November 1989, issued a new interest rate policy, allowing commercial banks to maintain their rates within an administered range for floor and ceiling. However, following a reform program that included interest rate liberalization in the financial systems that commenced in the beginning of 1990s, a new interest rate policy based on market forces replaced the then administered range of interest rates and allowed banks to set their own interest rates with effective from 19 February 1997. This market-based interest rate framework, so far, continued till the end of 2010s.

Thereafter, the BB issued a new directive that the lending interest rate would be maximum 9 percent to be charged by the scheduled commercial banks for all categories of unclassified loans, investments and advances except credit card effective from 1 April 2020. Coincidently, the cap guidance was issued in such a time when the economy was hit by the COVID-19 pandemic which, in fact, reinforces the criticality of access to easy financing for entrepreneurs in order to recover economic activities from the pandemic affect. The cap guidance on the lending interest rate was also aligned with the BB's cut on policy rates since March 2020 necessitated for implementing the government's stimulus packages to revive the economy from the COVID-19 fallout.

On the other hand, lowering the lending rates, however, led to decline in deposit rates because the banks have to reduce their cost of funds (deposit rate) for maintaining profitability but which, in turn, might be a concern on the flow of deposits to the banks in future. In this respect, the BB had remained always watchful for protecting depositor's interest as reflected in a circular issued earlier on 7 February 2017. That circular instructed that the banks need to be careful regarding declining trend of deposit rate, if any, which may discourage the depositors to deposit their funds in bank.

[1]This note has been prepared by Dr. Md. Salim Al Mamun, Deputy General Manager and Dr. Md. Ezazul Islam, General Manager. Views expressed in this policy note are authors' own and do not necessarily reflect that those of the Bangladesh Bank. Comments can be sent to: salim.mamun@bb.org.bd

Against the falling trend in deposit rate, the BB made a proactive action issuing a circular on 8 August 2021 that reads that, for fixing the interest/profit rate of a specific month in case of term deposits with the tenure of 3 (three) months or more, the average rate of inflation (12-month average inflation) of immediate last 3 (three) months shall be considered.

Now the question is being repeatedly raised that whether the capped lending rate or floor deposit rate (on the term deposit) would make any distortion in the banking sector from a market trend. Theoretically, interest rate will be dependent on market forces between demand of and supply for funds to be available for loan (Kohn, 1981)[2]. Apart from the market forces, government of Bangladesh had put utmost importance for increasing investment and, therefore, had a plan to bring down the interest rate to single digit as lower lending rate can help create conducive environment of investment, and accordingly, the BB issued the cap guidance just at the onset of the COVID-19 pandemic. Therefore, it is critical to review the trend in lending and deposit rates by type of banks[3] during and before the COVID-19 period for understanding the impact of the latest BB's imposition on the market interest rates. This note considers monthly and quarterly data for a period during 2017-2021, while comparing the impacts for the period between before the COVID-19 pandemic and during the pandemic.

II. Development of policy rates and market interest rates

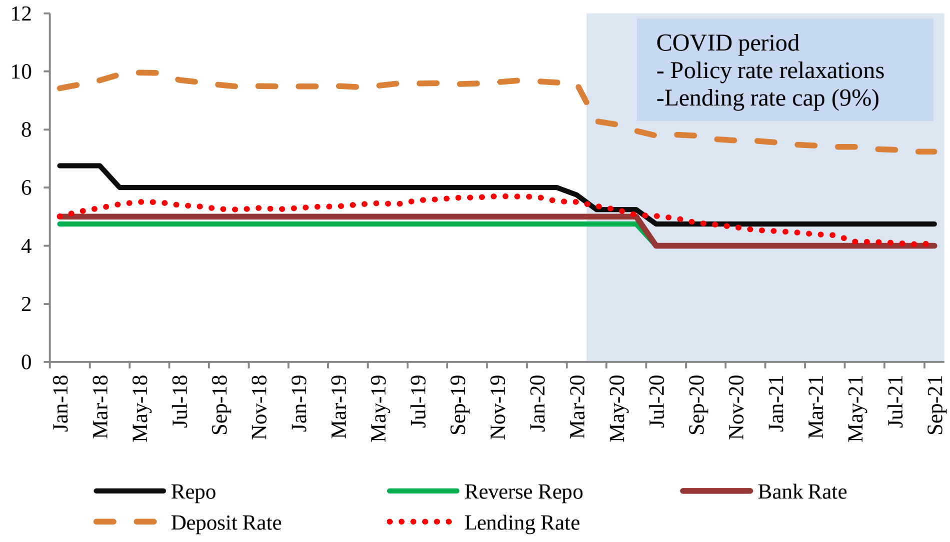
In the wake of COVID-19 pandemic in Bangladesh in March 2020, the BB reduced the major policy rates in order to ensure adequate credit flow to the pandemic affected economy. As part of the policy relaxations, the BB cut its cash reserve ratio (CRR) by 150 basis points (from 5.50 percent to 4.00 percent) in two steps during March-April 2020 (Chart 1). The BB also slashed its repo rate and bank rate by 125 basis points (from 6.00 percent to 4.75 percent) in three steps during March-July 2020 and 100 basis points (5.00 percent to 4.00 percent) in July 2020, respectively, for reducing the cost of borrowings. Reverse repo rate was decreased to 4.00 percent in July 2020 after remaining unchanged at 4.75 percent since January 2016.

Chart 1 indicates that both the lending and deposit rates declined gradually during COVID-19 pandemic period, consistent with easing of policy rates. The lending rate (weighted-average) for type of all banks was 9.7 percent in 2018 and declined slightly to 9.6 percent in 2019 on average. Moreover, the lending rate has been declining again since January 2020 which continued after the imposition of cap in April 2020.On the other hand, the weighted-average deposit rate also experienced a declining trend during COVID period which was 4.6 percent during April 2020 – June 2021on average.

[2]Kohn, M. (1981). A Loanable Funds Theory of Unemployment and Monetary Disequilibrium. *The American Economic Review*, *71*(5), 859–879. http://www.jstor.org/stable/1803470

[3] The banking sector of Bangladesh comprises four segments of scheduled banks: 6 (six) state-owned commercial banks (SCBs), 3 (three) specialized banks (SBs), 43 private commercial banks (PCBs) and 9 (nine) foreign commercial banks (FCBs).

Chart 1: Movements in policy and money market interest rates (in percent)

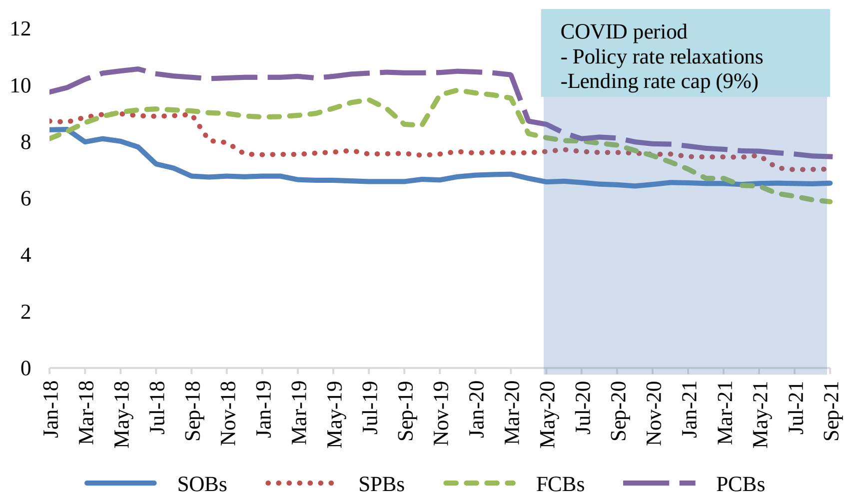


Source: Bangladesh Bank.

III. Lending rate structure by type of bank

Weighted average lending rate for all banks showed that it started to decline from May 2018 (9.96 percent) and reached 7.2 percent in September 2021. Accordingly lending rates for PCBs and FCBs showa declining trend during COVID-19 period, while that for SCBs and SBs remained stable before and during the pandemic period (Chart 2).In fact, the declining trend of lending rates for PCBs and FCBs started before the COVID-19 pandemic and the Chart also shows that the lending rates at the end of the period (September2021) under consideration were much lower than the 9 percent cap. The rates for SCBs, SBs, FCBs and PCBs registered at 6.5 percent, 7.0 percent, 5.9 percent and 7.5 percent, respectively in September2021, reflecting that the rate was mostly driven by market forces and essay monetary policy. Hence, the cap on lending rate has not distorted the market lending rate as the prevailing rates were already much lower than the 9 percent cap.

Chart 2: Trend in lending interest rates by type of bank (in percent)

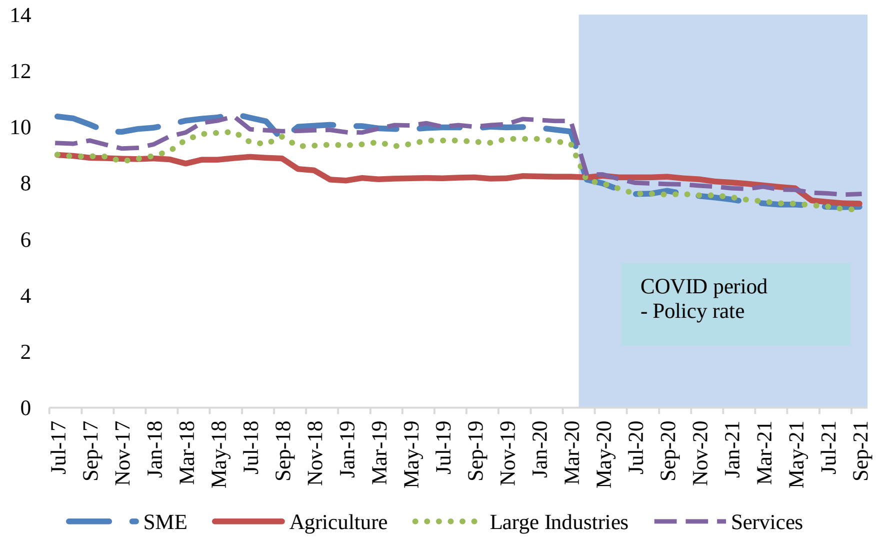


Source: Bangladesh Bank.

IV. Lending rate structure by economic sector

Weighted average lending rate for SME sector maintained at around 10 percent on an average before the cap introduced. Since this is a priority sector of Bangladesh for sustained economic growth, policymakers have long been argued for lowering the cost of fund to finance in SME activities. Introducing the cap declined the rate immediately in May 2021 below 8 percent and followed a gradual declining trend reaching 7.2 percent in September 2021 (Chart 3).But, lending rates for agriculture sector remained stable below 9 percent since the beginning of 2018. Weighted average lending rates for industries and services and services sectors came down significantly after May 2020 and reached 7.1 percent and 7.6 percent in September2021, respectively. Therefore, lending rate cap didn't distort the lending rate structure by economic sector; rather it helped maintain a lower and stable rate for SME activities.

Chart 3: Trend in Lending Interest Rates by Economic Sectors (in percent)

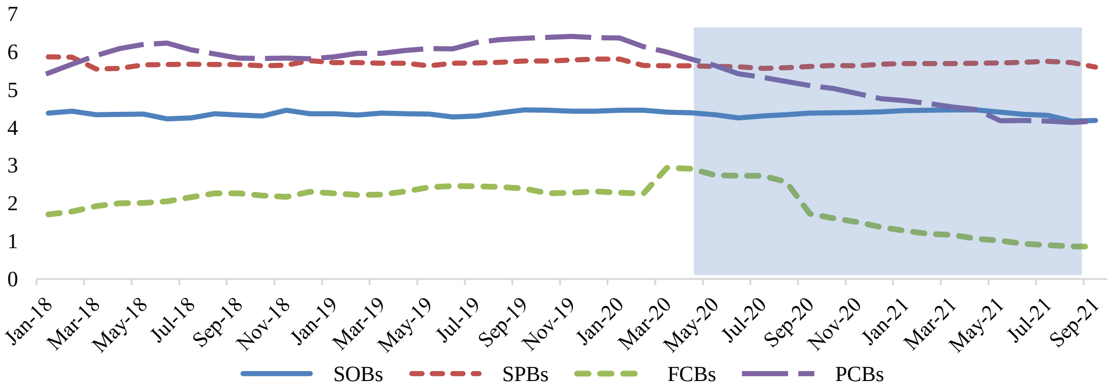


Source: Bangladesh Bank.

V. Deposit rate structure by type of bank

Similar to the trend of lending rates, weighted average deposit rates for PCBs and FCBs show a declining trend during COVID-19 period, while that for SCBs and SBs remained stable before and during the pandemic period (Chart 4). All the rates except for SBs remained below 5 percent in July 2021. The rates for SCBs, SBs, FCBs and PCBs registered at 4.2 percent, 5.8 percent, 0.9 percent and 4.2 percent, respectively in September 2021. However, these weighted average deposit rates do not reflect the rates for the term deposit because the weighted average rates are calculated by including the current account deposit and savings account which pay low or no interests to the depositors. For instance, the share of zero cost deposits in the banking sector was 12.3 percent in June 2021, foiling the weighted average rates from the rate paid to term depositors. However, the declining rate of weighted average rates prompted the BB to introduce a ceiling on the term deposits (3 months or more) so that positive real interest adjusted with inflation can be maintained.

Chart 4: Trend in Deposit Rates by Type of Bank (in percent)

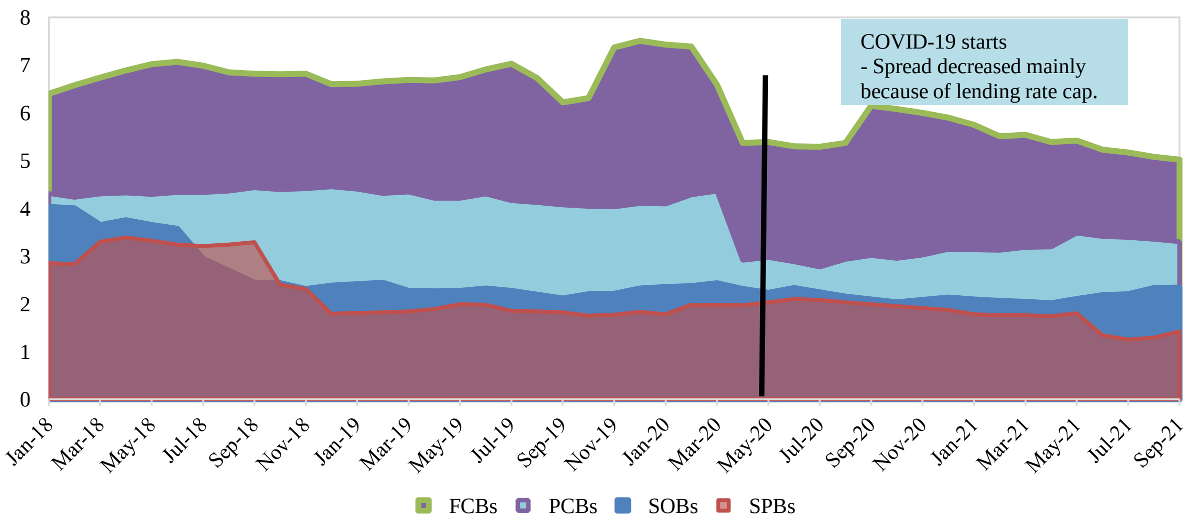


Source: Bangladesh Bank.

VI. Impact of current interest rate structure - spread, credit and deposit growth and excess liquidity

Following the imposition of lending rate cap, the spread between lending and deposit rates was lower in the COVID-19 pandemic period than the pre-pandemic period. The spread declined from 4.1 percent in March 2020 to 3.2 percent in July 2021 for banks by all types, reflecting a discipline in operational costs and risk premiums. The spread reduced from 2.4 percent, 2.0 percent, 6.6 percent and 4.4 percent in March 2020 to 2.3 percent, 1.4 percent, 5.0 percent and 3.3 percent for SCBs, SBs, FCBs and PCBs, respectively (Chart 5).

Chart 5: Trend in spread by type of bank (in percent)



Source: Bangladesh Bank

Chart 5 shows an opposite trend between growth rates of credit and deposits where deposit growth rate had an upward trend on the one hand, and credit growth indicated a decreasing trend during both pre-COVID and pandemic periods, on the other. Higher deposit growth rates coupled with lower credit growth piled up the excess liquidity in the banking sector and the excess liquid assets reached BDT 2.31 trillion in June 2021 as increased from 0.83 trillion in December 2019.

Chart 6: Deposit, credit and excess liquidity

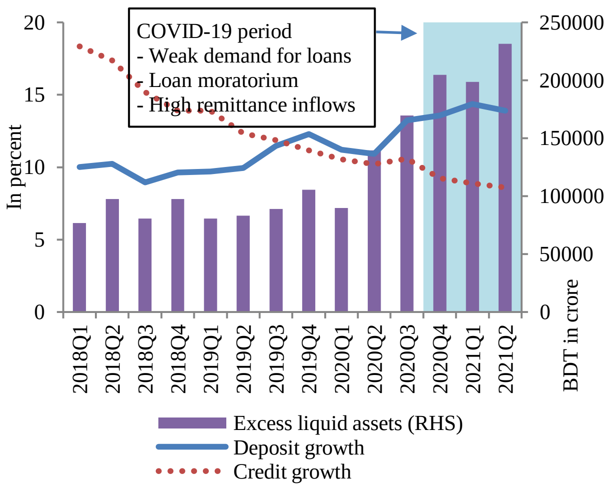
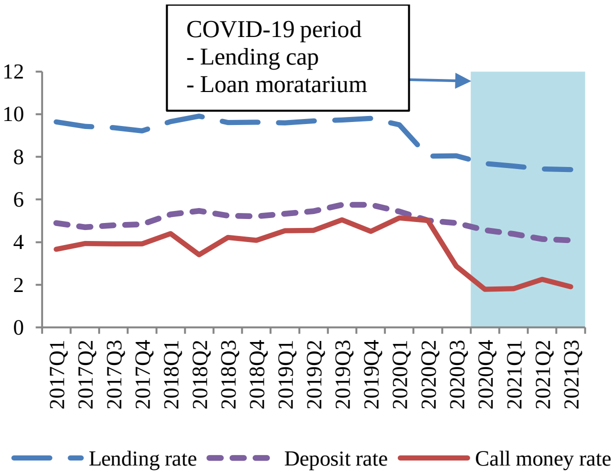


Chart 7: Interest rates and call money rate (in percent)



Source: Bangladesh Bank.

If call money rate is considered as a comparator against the prevailing lending rate, Chart 6 indicates that call money rates declined during the COVID-19 pandemic period and were much lower than both lending and deposit rates during the same period.

However, by comparing all types of deposit and fixed deposits to one another, this note finds that fixed deposit growth rate was slightly lower than all deposit growth rate at the end of June 2021 (Chart 7). The chart also shows that fixed deposit interest rates remained close to 6.0 percent during the pandemic period, which was positive even if inflation adjusted deposit rate is considered as reflected in Chart 8 during the COVID-19 period which, in fact, was much higher several quarters back.

Chart 8: All deposit vs. Fixed deposit (in percent)

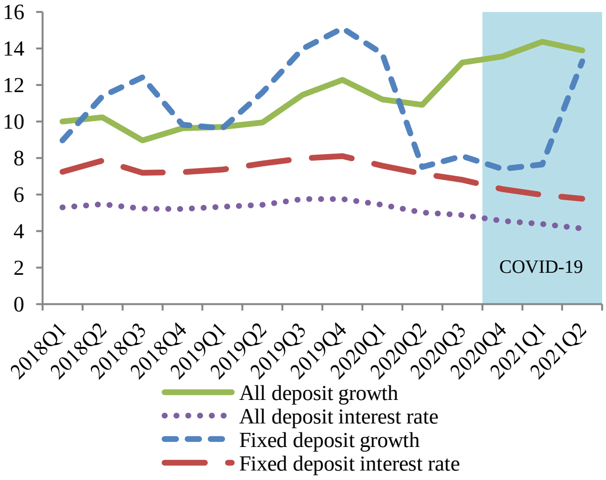
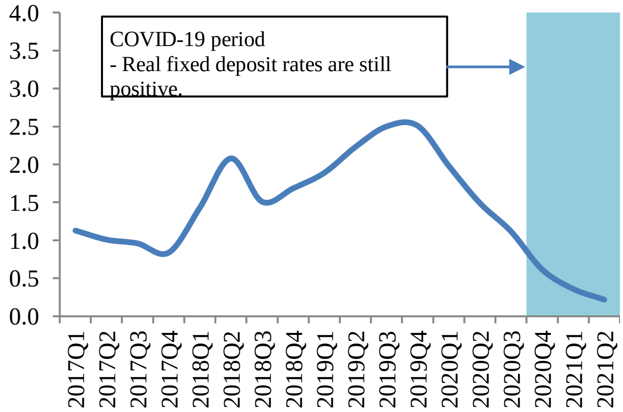


Chart 9: Inflation adjusted fixed deposit rates (in percent)



Source: Bangladesh Bank.

VII. Conclusion

This note has reviewed the trends of some key variables relating to deposit and lending rates and tried to understand whether the recent lending rates distort lending and deposit interest rates. The note finds that in tandem with policy relaxations which started in the wake of COVID-19 pandemic, the weighted average lending rates, particularly for PCBs and FCBs declined gradually during the pandemic period till date. It may conclude that since the current weighted average market lending rate which is 7.2 percent in September2021 is much lower than the cap, the cap has not created any distortion in the lending rate.

Another finding of this note is that both the lending and deposit rates, in fact, started to decline before the COVID-19 pandemic starts. Thereafter, the BB intervention on the lending rates was intended to recover the economic growth momentum from the COVID-19 fallout, without distorting the market channels as reflected in the much lower lending rates than the cap. The note also finds a gradual reduction of spread between lending and deposit rates after imposition of lending rate cap by type of bank, which indicate discipline in operational costs and risk premiums in the banking sector.

Though the interest rates on deposit have been decreasing overtime, the total volume of deposits maintained more than 13 percent growth during the pandemic period against the sluggishness in business activities as reflected in lower credit growth. This resulted in a huge excess liquidity amounting to BDT 2.24trillion in July 2021.

In case of fixed deposits, while the deposit rates were decreasing slowly during the COVID-19 period, banks still pay more than the prevailing inflation rates. The BB, in its latest instruction on deposit rate rationalization for the savings products with 3 (three) months or more, would like to ensure that depositor get return sufficiently above the prevailing inflation rates.

BB’s current policies are to boost investment activities, while supporting creation and retention of jobs as they are critical to recover the economy from the COVID-19 fallout. The single digit interest policy would ultimately reduce the cost of doing business, benefiting the borrowers and entrepreneurs in reinvigorating their economic activities. Reducing the management costs, strengthening efficiency and discipline in loan disbursement and recovery and introducing digital technology in banking operation are imperative for the banks in order to cope with the implementation of single digit interest rates. However, implementation of the single digit rates might not be smooth during the COVID-affected situation for which the BB may review its policies time to time and take necessary actions, accordingly.