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Rationalizing Interest Rate Spread in the Banking Sector: Some Policy Suggestions

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1. Background

In recent times, policy makers, private businesses, and others have become increasingly vocal in expressing their concern over the persistence of high interest rate spread (IRS) in the banking sector.¹ The concern emerges from the apprehension that high IRS acts against stimulating private investment and hence economic growth in the country and is a reflection of inefficiencies in the banking system. It is argued that high cost of borrowed fund filters out economically viable projects and reduces their expected returns with consequent adverse impact on private investment. On the other hand, low deposit rates discourage savings mobilization.

Despite the removal of restrictions and reforms in the banking sector to facilitate the adoption of a market oriented interest rate policy, interest rates are yet to become fully responsive to the market. In this context, the Bangladesh Bank (BB) as the regulatory authority of the country's banking and financial system has taken steps to persuade the banks to reduce the IRS in a rational manner. In view of the importance of the issue, this note examines the recent movements in IRS and reviews the underlying factors that are important in reducing IRS in the country's banking sector.

2. Recent Movements in IRS

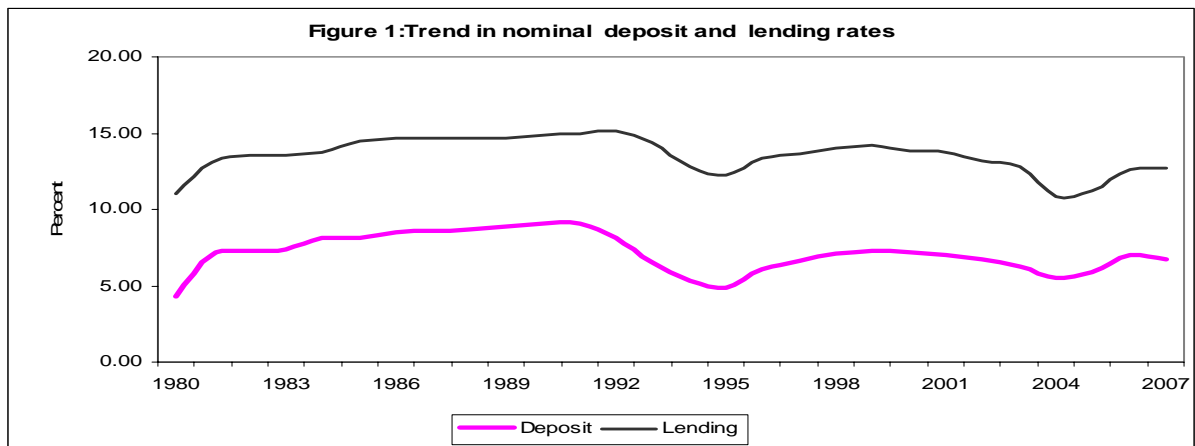
After independence, BB adopted an administered interest rate policy under which the level as well as the structure of interest rates was controlled in order to limit the cost of financial intermediation and ensure a reasonable structure of lending and deposit rates. The movements in lending and deposit interest rates (in nominal and real terms) since the 1980s are shown in Figures 1 and 2. In general, nominal interest rates were fixed at relatively low levels in the 1970s (the nominal deposit rate varied between 3.51 percent in 1975 to 4.27 percent in 1979 while the nominal lending rate was 11.28 percent in 1975 and 11.12 percent in 1979); and the interest rates maintained a slowly rising trend throughout the 1980s. With liberalization in the banking sector policies, interest rates started to decline in 1992 which continued till 1996. Afterwards, one can notice another trough in interest rates in 2004.² For real interest rates,

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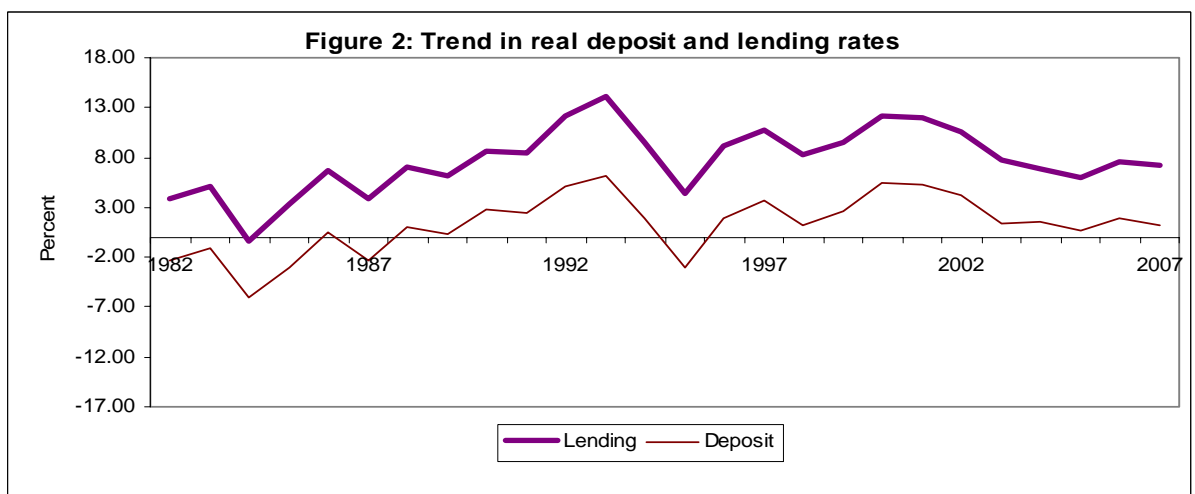
¹ Although IRS, measured as the difference between weighted average lending and deposit rates, has been considered in the present note, a related concept is the net interest margin (NIM) defined as the difference between interest expenses and interest income per unit of total bank assets. The NIM is treated as an important indicator of intermediation efficiency and the expectation is that NIM would decline as the banking industry matures and competition strengthens. The value of NIM for all banks was estimated at 2.65 in 2002 which declined to 2.17 in 2004. In India, NIM for all commercial banks for the two years was 2.57 and 2.87 respectively. See *Financial Sector Review*, 1(1), Bangladesh Bank.

² It may be mentioned that the structure of lending rate became highly complex, especially during the 1980s, due to introduction of more exceptions and special lending categories giving rise to proliferation of rates and varied degree of subsidization across sectors. As a result, the interest rate and credit structure became distorted. Moreover, real deposit rate remained negative particularly for most of the period of the 1980s due to high rate of inflation.

significant fluctuations can be noticed with real deposit rate becoming negative for a number of years in the 1980s and remaining very low in recent years. Having no clear guidelines to set the nominal interest rate structure prior to the 1990s, the complexity and rigidity of the administered lending and deposit rates significantly undermined domestic savings mobilization and efficient credit allocations in the economy. In the case of IRS, the policy thrust was to keep it low in order to ensure low cost of investment funds, although IRS remained high in practice.³



Source: *Scheduled Banks Statistics and Bangladesh Bank Quarterly*, various issues, Bangladesh Bank.



Source: *Scheduled Banks Statistics and Bangladesh Bank Quarterly*, various issues, Bangladesh Bank.

³ According to Wahba and Mohieldin (1998), the desired IRS can be calculated using the formula : $(LR-DR) = \{k/(1-k)\} DR$, where LR is the lending rate, DR is the deposit rate, and k is the required reserve ratio. See, J. Wahba and M. Mohieldin, "Liberalizing Trade in Financial Services", *World Development*, 26, 1331-1348, 1998. Using the methodology, the desired IRS comes to an average of 1.03 for the 1970s, 1.92 for the 1980s, 1.76 for the 1990s, and 1.53 over the period 2000-2007. As against this, the actual IRS was 7.03, 6.13, 6.95, and 6.06 respectively during the four periods. This shows that the difference between the actual IRS and the desired IRS has somewhat narrowed down in recent years (an average of 4.53 during 2000-2007 relative to 5.19 in the 1990s). It should, however, be mentioned that the above concept of desired IRS considers the required reserve ratio only and does not take into account other factors that the banks consider in setting the deposit and lending rates and hence the IRS in the real world.

With liberalization toward a market oriented interest rate policy under the Financial Sector Reform Program (FSRP) in the 1990s, the banks were allowed to set lending and deposit interest rates within bands set by BB; later on the bands were removed allowing the banks to set interest rates along the lines of market conditions. Finally, other restrictions were removed in 1999 enabling the banks to enjoy greater flexibility in setting interest rates.⁴ Despite these developments, IRS remained high with no perceptible change relative to earlier years.

In recent years, IRS showed a somewhat declining trend till the end of 2004, after which a rising tendency is observed (Table 1). Among various groups of banks, the IRS was the lowest for specialized banks (SBs) at 2.95 in December 2007 followed by 5.70 for private commercial banks (PCBs), 5.95 for state owned commercial banks (SCBs), and the highest of 8.83 for the foreign commercial banks (FCBs). Moreover, one can notice differing trends in movement of IRS over the years. While the IRS of SBs has generally followed a declining trend, IRS for other groups shows mixed trends along with significant year to year fluctuations.⁵

Table 1: Recent movements in IRS

Period	Weighted average of all banks			IRS by bank groups			
	Deposit rate	Lending rate	IRS	SCBs	SBs	PCBs	FCBs
Jun 2001	7.03	13.75	6.72	5.98	4.86	7.96	7.88
Jun 2002	6.74	13.16	6.42	5.74	5.11	7.23	7.83
Jun 2003	6.30	12.78	6.48	6.14	6.01	6.63	7.62
Jun 2004	5.65	11.01	5.36	4.88	3.64	5.58	7.22
Jun 2005	5.62	10.93	5.31	5.14	3.58	4.85	8.33
Jun 2006	6.68	12.06	5.38	5.37	3.64	5.05	8.52
Jun 2007	6.85	12.77	5.92	6.04	2.94	5.05	8.76
Dec 2007	6.77	12.75	5.98	5.95	2.95	5.70	8.83

Source: *Scheduled Banks Statistics* and *Bangladesh Bank Quarterly*, various issues, Bangladesh Bank.

How does the IRS in Bangladesh compare with IRS in other countries? Such comparison is difficult to make since consistent data on IRS are not available across different countries. The data given in Table 2 show that the IRS was highest in Sri Lanka in 2006 followed by IRS in Pakistan, Bangladesh, and India. Compared with 2006, IRS in Bangladesh increased in 2007 and became the highest while IRS in India and Pakistan declined. Moreover, movements of IRS over the five years ending in 2007 show relatively wide fluctuations in Pakistan and steady rising trend in Sri Lanka. In the case of Bangladesh, a rising trend can be observed since 2004.

⁴ For details, see *Financial Sector Review*, 1(1), May 2006, Bangladesh Bank. It should, however, be emphasized that despite the removal of all formal restrictions, lending and deposit rates are still not fully responsive to market conditions due to the practice of directed lending to specific sectors (e.g. state owned enterprises especially in energy and civil aviation sectors) mediated through the state owned commercial banks and the specialized banks as well as the existence of other imperfections in the banking sector.

⁵ Overall, it appears that the FCBs gained the most from high IRS that resulted from low deposit rates, high lending rates, and their better quality of loan portfolio. On the other hand, SCBs and SBs incurred larger losses or earned lower profits. For details, see Table 5 below.

Table 2: Trends in IRS of selected South Asian countries

Year	Pakistan	India	Sri Lanka	Bangladesh
2003	6.63	6.09	3.68	6.11
2004	5.46	5.17	4.86	5.27
2005	6.83	4.50	5.93	5.38
2006	6.43	4.75	7.14	5.61
2007	5.14	4.25	...	5.98

Source: Publications of respective central banks

3. Factors Influencing IRS

Conceptually, the IRS reflects the cost of intermediation activities including operating costs and liquidity risks that the banks bear in linking the savers and the investors. In addition, banks in Bangladesh incur several other costs which are relatively high such as the high cost of non-performing loans (NPLs), high administrative and incidental costs including high expenses that the banks incur in setting up new branches and for attracting and retaining skilled personnel, for advertising, and for other expenditures that the banks undertake to increase market share and business.⁶ This is typical in low income countries with relatively underdeveloped financial markets where IRS remains high due to many factors, including high operating costs of banks, absence of competition in the banking system, high inflation and corporate tax rates, and other characteristics of the financial system.

In Bangladesh, the financial system is presently undergoing rapid transition where institutions and instruments are being developed and strengthened. Moreover, the financial market is segmented which, along with other limitations, undermines the economy's allocative efficiency and productivity. These characteristics of the country's financial system have a significant impact on the banks in setting deposit and lending rates and consequently the IRS. Obviously, for ensuring a rational level of IRS, it is important for Bangladesh to create a liberalized, well-regulated, and competitive environment in the financial sector critical to realizing a developed and matured financial market with diversified products.

In identifying the factors that contribute to the persistence of high IRS in Bangladesh, 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.⁷ In practice, such factors could cover elements both internal and external to the banking sector. It is more likely that the IRS in Bangladesh is indicative of interactions of three sets of factors: (i) high costs of intermediation as a consequence of large non performing loan (NPL)⁸; (ii) practice of setting

⁶ Some of these costs are unusually high in Bangladesh including the cost of NPLs. Similarly, incentive packages given to the bank executives are high relative to Bangladeshi standards in view of the short supply of and strong competition for skilled personnel among the banks. Also there exist strong tendencies among the banks (especially PCBs) to spend lavishly in setting and decorating new bank branches to attract customers. It is sometimes argued that the cost of non-interest bearing assets like cash reserve requirement (CRR) and the cost of under-remunerated assets such as statutory liquidity ratio (SLR) contribute to high IRS in Bangladesh. While this may be partly true, such ratios are higher in India than in Bangladesh but IRS, as shown in Table 2, has remained consistently lower in India than in Bangladesh over the last five years.

⁷ The IRS did not change much since the 1980s. The average value of IRS was 6.13 in the 1980s, 6.95 in the 1990s, and 6.06 during the period 2000-2007.

⁸ This argument is more applicable to SCBs and SBs but not to all PCBs or FCBs. It is true that the past interventionist policies did not affect all banks similarly. It affected the first and the second generation banks

higher than competitive deposit interest rates resulting in high lending rates and hence IRS⁹; and (iii) existence of forces favoring high IRS in a segmented and non-competitive banking sector.¹⁰ We shall highlight a few key areas in this note, such as high cost of liquidity, distribution of market power in the banking system, and relative importance of interest vis-à-vis non-interest sources of income and expenditure of the banks.

Costs of liquidity

As seen earlier, high IRS in Bangladesh has a long history that dates back to the initial years after Independence. Traditionally, the financial policies including monetary policy have been influenced significantly by fiscal activism in Bangladesh. Since the 1970s, the interventionist policies, especially the state control on lending, led to the emergence of many evils in the banking sector. The BB followed an administered interest rate policy until the end of the 1980s to limit the cost of financial intermediation and direct credit to priority sectors. A number of exceptions were introduced and special lending categories were identified for directing credit, leading to centrally administered rather than market driven allocation of credit. Moreover, the banking system accumulated a huge amount of classified loans due to various reasons including politically motivated loan disbursement to unviable projects and build up of bad loans due to corruption, low technical skills especially in risk management, and inefficient portfolio management.¹¹ This led to high ratios of NPLs and, with limited supply of funds, higher cost of capital to prospective borrowers.¹²

who entered the market prior to the 1990s. This includes SCBs, SBs, and some PCBs who accumulated large classified loans and are currently constrained to maintain capital adequacy levels in accordance with tighter BB rules. These banks therefore are likely to have a tendency to recover the losses at least partly through imposing higher loan charges. However, new generation PCBs and FCBs do not have such pressures. In a competitive banking market, simultaneous operation of these two types of banks would have constrained the capacity of the banks with serious capital adequacy problems to maintain high IRS due to potential threat of losing the market share in lending operations. This, however, does not appear to be big problem in Bangladesh as the banking system is still segmented.

⁹ This refers to the argument that the banks are often forced to follow the practice of setting deposit rates reflecting non-market rates of return in order to attract and retain deposits. The competition emerges largely from national savings directorate (NSD) certificates, which is the principal device of public (non-bank) borrowing for financing budget deficits. The interest rate on three-year NSD certificate has been 11.5 percent since December 2005 while the same on five-year certificate is 12 percent. On the other hand, deposit rates show wide variations across different bank groups. In December 2007, deposit rates were 4.93 percent for SCBs, 6.71 percent for SBs, 8.19 percent for PCBs, and 5.05 percent for FCBs. This can be compared with the lending rates in the same period, which was 10.88 percent for SCBs, 9.66 percent for SBs, 13.89 percent for PCBs, and 13.88 percent for FCBs. As such, IRS varied from 5.95 for SCBs, 2.95 for SBs, 5.70 for PCBs, and 8.83 for FCBs. It can be seen that PCBs offered the highest deposit rate and their lending rate was also the highest.

¹⁰ This argument rests on the presumption that each bank group (SCBs, SBs, PCBs, FCBs) holds a distinct segment of the credit market, the demand features of which are catered by the specific group only. The persistence of wide differences among the lending rates of different bank groups and the capability of sustaining high lending rate (and IRS) by a specific group (e.g. FCBs) lends some support to this assertion.

¹¹ Despite significant reforms, the gross classified loans in total loan outstanding stood at 32 percent in 1995 which declined to 14 percent in September 2007. It may be mentioned that Bangladesh had a non performing loan to total loan ratio of 13.2 percent in 2006 compared with 3.5 percent for India and 8.3 percent for Pakistan. See, *Financial Sector Review*, 3(1), December 2007, Bangladesh Bank.

¹² In 2006, while the total NPL ratio was 13.2 percent, the ratio stood at 22.9 percent for SCBs, 33.7 percent for SBs, 5.5 percent for PCBs, and 0.8 percent for FCBs. This shows the high share of poor quality assets especially of SCBs and SBs. With high NPL ratio, the banks fail to maintain the required level of provisions against their NPLs. For instance, the provision maintenance ratio in 2006 was 29.5 percent for SCBs, 61.5 percent for SBs, and 82.2 percent for PCBs. Only in the case of FCBs, the ratio was 140.9 percent. These no doubt have implications for high IRS that exists in the country.

Under the FSRP of the 1990s, a market oriented interest rate policy was introduced with interest rate bands for different categories. Banks could set lending and deposit rates within the band. Initially, the government paid subsidies for lending below a shadow market rate determined by BB and floor and ceiling rates were determined for deposits. Later the prescribed bands were made applicable only to agriculture, exports, and small industry sectors and deposit rates were freed incrementally. In August 1999, interest bands on agriculture and small and medium enterprise (SME) loans were also removed and the banks were allowed to set both lending and deposit rates in line with market conditions, which were previously determined by BB.

Despite liberalization, interest rates are not fully responsive to market conditions as yet due to several rigidities in the banking system, including directed lending to priority sectors and to state owned enterprises (SOEs), especially by the SCBs. At present, BB uses market oriented instruments (SLR and CRR) and employs repo, reverse repo, and BB bill rates as policy instruments for influencing financial and real sector prices. Recent evidence also shows the existence of a close link in movement of different money market rates and a converging tendency of the market clearing rates toward BB's policy rates.¹³

Besides, the deposit rates in the banking sector remain highly insensitive to the market due to significant public sector borrowing through NSD certificates and similar instruments offering non-market yields. Some analysis shows that a rise in three-year NSD certificate rate triggers shifts in the weighted average deposit rate, savings deposit rate, and the rate on fixed deposit with one-year to less than two-year maturity in the positive direction.¹⁴ The deposit rate and the quarterly import growth are also observed to influence the lending rates offered by the scheduled banks. Thus several factors exist that create distortions in the interest rate structure of the banking system in the country.

As for the banks, high IRS is seen as a premium for bearing credit risk which is perceived high in view of the long default culture in the country's banking system. Obviously, the single most important source of the risk is the possibility of loan default. In addition, there exist several other sources of perceived risk, such as funding longer term credit with short term deposits by the banks in the absence of a well-functioning and vibrant capital market that precludes better risk sharing, and potentially higher future interest rates with rising rate of inflation.¹⁵

Moreover, the perceived risk of an individual bank depends on many other factors, such as its risk aversion behavior, its share of transaction in the credit market, and the degree of volatility of interest rates in the financial market. Necessarily, IRS would be higher in a market where interest rate volatility is high and mechanisms to hedge interest rate uncertainty are absent. Under the circumstances, setting a high IRS acts as a convenient mechanism for the banks to screen out high-risk borrowers.

¹³ See, *Monetary Policy Review*, 3(1), October 2007, Bangladesh Bank.

¹⁴ See *Financial Sector Review*, 1(1), May 2006.

¹⁵ The capital market has played a minor role in investment financing in Bangladesh even in recent years. The provisional figure for FY07 shows that the amount of industrial term loans disbursed by banks and financial institutions stood at Tk 124.0 billion compared with only Tk. 3.1 billion by new capital issues through private placements and public offerings in the capital market. See Bangladesh Bank, *Annual Report 2006-2007*, Dhaka.

Interest and non-interest income and expenditure

The actual IRS consists of the impact of different components that the banks consider in setting the margin, such as reserve costs, loss provision, and the target level of profitability. In addition, the banks are likely to consider operating costs (non-interest costs) as well as non-interest income flows (e.g. commission and fee income) in setting the IRS. Obviously, low operating and reserve costs could induce the banks to reduce the spread. On the other hand, inefficiencies in bank operations and adverse economic and market conditions are likely to contribute to high overhead costs. This shows that differences in IRS across banks may be the reflection of conscious choice regarding whether to bear high overhead costs and set high IRS on the one hand or ensure efficiency and better performance and operate under low IRS on the other. Moreover, variations in IRS over different banks reflect the efficiency in portfolio choices and credit allocations of the banks.

The balance sheets and income statements of the banks can, therefore, provide important clues relating to areas where actions could be targeted to yield positive results in reducing the IRS. In general, the banks could be induced to lower IRS if non-interest income increases. Similarly, the banks are likely to keep IRS high if they suffer or foresee credit losses, increasing operating expenses, and are obliged to maintain high return on capital. High interest rates or inflation expectations are also likely to lead to high IRS. Moreover, the ability to deploy short term surplus funds and/or raise funds in the event of liquidity crisis can have important implications on the level of IRS set by the banks. Table 3 shows recent changes in the values of some indicators having implications on IRS in the banking sector.

Table 3: Some indicators related to IRS

	Jun 2005	Jun 2006	June 2007	Dec 2007
Lending rate (percent)	10.93	12.06	12.77	12.75
Deposit rate (percent)	5.62	6.68	6.85	6.77
Interest rate spread (percentage points)	5.31	5.38	5.92	5.98
Credit-deposit ratio (percent)	0.84	0.86	0.84	0.83
Risk weighted capital-asset ratio (percent)	7.11	8.02	6.48	7.37
Gross NPL (percent)	15.79	16.59	13.96	13.23
Return on assets (percent) (end December)	0.60	0.79	...	0.89

Source: *Scheduled Banks Statistics* and *Bangladesh Bank Quarterly*, various issues, Bangladesh Bank.

The table shows that, between June 2005 and June 2007, the weighted average lending and deposit rates increased; but the lending rate increased faster so that the IRS widened over the period. In December 2007, the lending rate fell marginally but the deposit rate declined more causing the IRS to increase further. The gross non performing loans (NPL) significantly declined after June 2006 reflecting lower credit losses and consequently higher returns on assets. On balance, the impact of these improvements should be to lower the IRS. The credit-deposit ratio, on the other hand, remained relatively stable over the period, so that rising interest rates resulted in a higher cost of unutilized funds.¹⁶

Several measures of earnings and profitability along with IRS for different bank groups (SCBs, SBs, PCBs, FCBs) are given in Table 4. It shows increasing interest and non-interest income for all bank groups as share of total assets, but similar shares for expenditure have also increased. The return on assets, however, shows increasing trend (except for SCBs and SBs). The reduction in costs and/or increase in other income, especially non-interest income,

¹⁶ During end June 2007, total excess liquidity as a share of deposits for all banks was 7.5 percent. The ratio was 7.6 percent for SCBs, 1.5 percent for SBs, 7.0 percent for PCBs, and a high of 14.3 percent for FCBs.

should therefore have a positive impact on reducing the IRS. In this respect, the FCBs have a significantly higher non-interest income to asset ratio (nearly 4 percent) compared with around 3 percent for the PCBs and slightly higher than 2 percent for the NCBs,

For increasing non-interest income, it is important for the banks to target on providing value added services. For example, the traditional fee and commission based income streams can be broad based to cover both modern and expanding consumer, corporate, and investment banking services. In addition, many areas in retail banking may be tapped covering advisory and asset management services including sale of insurance and mutual fund products, payment products, electronic bill payments, credit and smart cards, and other prospective areas. In the corporate sector, fee based revenue arising out of traditional trade finance can be significantly enhanced through capital raising and similar other activities, such as syndicated loan, primary capital market offering, securitization, and debt and equity placements. As the capital market develops, secondary market broking, international fund raising, and corporate trust services can also emerge as useful sources of raising non-interest income.

Table 4: Earnings and profitability by bank groups

	December 2005	December 2006	December 2007
Interest rate spread			
SCBs	5.41	5.63	5.95
SBs	3.66	3.19	2.95
PCBs	5.07	5.45	5.70
FCBs	7.87	8.12	9.07
Interest income- asset ratio (%)			
SCBs	5.59	5.19	4.26
SBs	2.65	3.24	3.46
PCBs	7.81	8.17	8.34
FCBs	7.37	4.84	7.63
Interest expenditure- asset ratio (%)			
SCBs	4.03	4.04	3.46
SBs	1.79	2.35	2.78
PCBs	5.23	5.96	5.78
FCBs	2.63	4.84	3.30
Non interest income- asset ratio (%)			
SCBs	1.41	2.02	2.37
SBs	0.37	0.58	0.81
PCBs	2.07	2.77	3.07
FCBs	3.23	2.35	3.80
Non interest expenditure- asset ratio (%)			
SCBs	1.61	1.76	1.59
SBs	1.08	1.24	1.27
PCBs	1.96	2.11	2.14
FCBs	2.21	1.42	2.13
Return on assets (%)			
SCBs	-0.10	0.00	0.00
SBs	-0.13	-0.15	-0.27
PCBs	1.06	1.07	1.28
FCBs	3.09	3.34	3.10

Source: Department of Off-site Supervision and *Bangladesh Bank Quarterly*, Bangladesh Bank.

Access to information and distribution of market power

Within the structure and at the level of efficiency at which the banks operate at present, imperfect access to information has significant influence on IRS especially through its effect on the cost of credit. Thus, ensuring greater access to credible information could play an important role in reducing uncertainty in the credit environment and thereby reduce the IRS. Obviously, interest rate volatility and broader socioeconomic uncertainty contribute to widening of IRS. This indicates that reducing such uncertainties and removing the asymmetric access to information constitute important elements of an effective IRS management policy.

Similarly, operating costs including non-interest expenditure which contribute to high IRS are linked, among others, to market power and the market share of individual bank/bank group that affect its cost of doing business. For efficiently managing operating costs, it is important for the banks to bring greater efficiency in bank operation, especially relating to management of personnel, processes, and technology. By making judicious choices with respect to these elements, the banks can significantly improve productivity in different operations and achieve substantial reduction in operating costs.

It would also be important for the banks to manage interest rate volatility through adopting best practices in fund management. Regular monitoring of risk elements and asset-liability gaps, for example, enables the banks to better manage liquidity risks that can contribute to lowering the IRS. Similarly, introduction of hedging mechanisms can play useful role that may start with short-term derivatives, such as forward rate agreements and interest rate swaps before moving to sophisticated options and longer dated transactions.

As mentioned earlier, the distribution of market power and segmentation of the market give the banks added leverage in setting the deposit and lending rates. Table 5 shows the shares in total deposits and total advances by the four bank groups in the country. In the case of deposits, the share of SCBs has consistently declined over the 1990 and 2007 period and its market share has been captured by the PCBs. The interest rate offered by the PCBs also remained significantly higher than that by the SCBs. On the other hand, the FCBs, despite paying the lowest interest rate to the depositors, have succeeded in retaining their market share almost intact. A similar picture also emerges for the SBs although their deposit interest rate has been higher.

Table 5: Shares in total deposits and total advances by bank groups

	SCBs		SBs		PCBs		FCBs	
	Share	Int. rate	Share	Int. rate	Share	Int. rate	Share	Int. rate
Deposits								
1990	63.4	9.29	4.6	11.52	24.8	9.13	7.2	6.58
1995	61.7	4.80	6.0	6.50	27.5	4.92	4.8	2.67
2000	55.8	7.65	6.0	8.94	30.3	6.70	7.9	4.74
2005	42.1	4.63	6.2	5.45	45.1	6.83	6.7	3.75
2007	35.4	4.96	5.7	6.50	52.2	8.44	6.7	4.81
Advances								
1990	52.0	14.06	21.5	15.37	20.4	16.44	6.0	15.54
1995	52.4	11.28	18.0	12.76	25.0	14.00	4.6	11.00
2000	48.5	13.47	17.1	13.63	29.2	14.82	5.2	12.80
2005	36.0	9.77	9.5	9.03	47.5	12.08	7.0	11.68
2007	28.8	11.00	8.8	9.44	54.6	13.43	7.8	13.57

Source: *Scheduled Banks Statistics*, various issues, Bangladesh Bank.

For advances, the changes are similar. The SCBs and the SBs lost their market share significantly while the PCBs more than doubled its market share between 1990 and 2007. This substantial gain took place despite substantially higher interest rates on advances (the rate was the highest among all bank groups since the 1990s) charged by the PCBs relative to the SCBs and the SBs. On the other hand, FCBs continued to maintain, and succeeded in increasing in recent years, the market share as a group despite charging higher interest rates on advances relative to SCBs and SBs. The above trends seem to suggest the existence of segmented market and non-competitive outcomes especially in the distribution of advances by different bank groups. It seems non-interest considerations play a more important role in mobilizing deposits and providing advances than the interest rates of different bank groups.

4. Some Policy Implications

From the above analysis, it is clear that proper management of IRS requires both systemic actions as well as actions at the individual bank level tailored to address specific weaknesses that hinder its operational efficiency and performance.

Developing alternative risk assessment mechanism

The banks, in the absence of any operational and efficient mechanism, tend to set and maintain high IRS so that it can screen out high-risk borrowers. It is important therefore for the BB to provide guidance and assistance in developing institutions that would employ modern and efficient techniques of measuring and disseminating risk profiles of potential borrowers to the banks. Such efforts should also include appropriate legal and other measures for adopting rigorous accounting standards by the firms, implementing fair disclosure regulations, setting up of credit bureaus and credit rating agencies with professional competence, installing mechanisms for wide sharing and exchange of credit information among banks and other stakeholders, and other measures for ensuring transparency and accountability in the banking sector.

Ensuring better liquidity management

Under the current market-oriented practice adopted by the BB, unilaterally imposed regulatory mechanisms are unlikely to contribute toward reducing the IRS in a sustained manner. Raising reserve ratios and/or increasing bank equity, for example, would more likely to induce the banks to increase IRS to cover the higher cost of loanable funds. On the other hand, measures like introduction of deposit insurance should contribute to reducing the IRS. Similarly, other plausible measures of reducing interest rate volatility and IRS include introducing refinance facility and market stabilization funds, ensuring greater predictability of BB's stand on inflation and monetary policy, and creating higher capability to procure funds and wider access to international markets for funding and hedging the interest rate risks.

Improving institutional efficiency

Since the financial sector reform program aims at bringing a competitive and liberalized environment leading to more integrated and efficient functioning of the financial markets, it is important for BB to adopt the deposit and lending rates (and hence IRS) of different bank groups as important indicators, monitor their movements regularly, and adopt appropriate measures to bring convergence toward competitive rates except for risk and other real

differences. For ensuring such a competitive level of IRS, the banking sector needs to move toward achieving a level of institutional efficiency that would ensure effective competition, efficient banking operations, and credible risk and portfolio management within an environment characterized by high standards of regulation and supervision by BB.

Strengthening local banks

As the present review indicates, the local banks (SCBs, PCBs, and SBs) are weak compared with the FCBs on most counts of earning and profitability indicators and hence face unfair competition. For these banks, the better return on capital is mainly due to their small paid up capital relative to total equity.¹⁷ It is important therefore for the BB to use its regulatory power to strengthen the capital base of the local banks. This is necessary to strengthen the local banks especially in view of the increasing competition that the local banks will have to withstand as the banking sector opens up through reform and liberalization enabling greater participation of the foreign banks.

Access to information

Access to credible and timely information on financial and credit market issues is critical to maintaining a rational level of IRS. For this, it is important to install mechanisms for ensuring both greater transparency and accountability. In addition, measures are needed to reduce the current asymmetry in access to information for the banks and other stakeholders. This needs the setting of required standard of disclosure in the accounting framework and the corporate governance hierarchy including a code of conduct for the corporate entities covering both financial and management information.

For effective implementation of such a framework, a credit information bureau (CIB) could be established in addition to the current practice of publishing bi-annual reports by BB. The bi-annual report provides defaulter listings which identify the actual defaulters. From the IRS perspective, it is important to generate information on the likelihood of default of the potential borrowers as well. The proposed CIB would provide such information on potential borrowers of the banks. It should function like an autonomous corporate entity which will provide relevant credit information on individual/corporate borrowers to help assess credit worthiness by the banks. Based on such information, the banks may be allowed to charge differential lending rates akin to price discrimination based on credit rating (rather than charging the same rate to all borrowers despite their different credit ratings). On its part, the CIB will generate credible credit ratings using financial and related data on individuals and businesses from relevant data providers including businesses, utilities, public agencies, and legal institutions. In this context, BB could implement regulations similar to US Fair and Accurate Credit Transactions Act that would safeguard the rights of borrowers in terms of access to and use of negative and/or disputed information.

¹⁷ This partly reflects the government's initial policy of providing incentives to establish private banks with relatively small amount of capital. The banks, however, succeeded in building up equity from retained earnings which could be adversely affected with reduced earnings through lower IRS.

5. Concluding Remarks

The present analysis suggests that the high IRS that exists in the country's banking sector is largely the outcome of inefficiencies and lack of competition in the banking system. As such, ensuring a rational IRS requires effective measures to address these weaknesses. In real terms, the deposit rate is low (1.2 percent in 2007) so that the scope of lowering IRS through reducing the deposit rate is likely to be counterproductive. Any effort to reduce the deposit rate may adversely affect deposit mobilization by the banks. Moreover, since returns on alternatives to institutional savings are high particularly in the present situation of rising inflation, any move to depress the return on savings by the banks would further strengthen the trend of holding savings in non-financial assets, especially in urban real estate and rural agricultural land, creating destabilizing forces in these markets. It is important therefore for the banks to improve their performance efficiency as the most important tool of reducing the IRS.

In this context, the challenge of the local banks (SCBs, PCBs, and SBs) is to improve their earnings and profitability as the sustainable tool of reducing the IRS. The FCBs, on the other hand, have maintained high levels of IRS although these banks have enjoyed good earnings and profitability largely due to their more efficient operation and risk management, market segmentation, and imperfect distribution of market power in the banking sector.

At present, the prime objective of reducing the IRS is to lower the lending interest rate following the expectation that this would stimulate investment and bring higher economic growth. For realizing such outcomes, it is important to recognize two important factors. *First*, as a component of the monetary policy instruments, the desired impact of changes in the lending rate on investment needs the market to respond which, in a country like Bangladesh, takes time. *Second*, lowering the lending rate alone may not be adequate to stimulate investment if other determinants such as macroeconomic and related policies, expectations of the investors, legal and institutional framework, and socio-political regime are not conducive to ensuring an investment-friendly environment in the country.

It is also important to recognize that within the market determined interest rate policy regime currently being pursued by BB, the banks are free to set both lending and deposit rates in line with market conditions. In a situation like this, the major tool available to BB for influencing the interest rate structure is moral suasion and urge the banks to become more aware of and responsive to their corporate social responsibility. In order to be effective, such efforts should be supplemented by sharing of credible research results and information on market conditions and public policy concerns so that the banks can foresee macroeconomic and related financial developments and take appropriate decisions. Obviously, coercive action is not consistent with the fundamentals of a market economy and reducing the IRS is to be achieved through using market responsive instruments by BB. Moreover, a more coordinated use of fiscal policy is essential so that the burden of reducing the IRS is not borne by monetary measures alone.