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Single Digit Interest Rate: Bangladesh Perspective

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Abstract

The objective of this study is to examine if the current move of single digit interest rates, i.e., 6 percent for deposits and 9 percent for loans are plausible and practiced by banks in Bangladesh. The study intends to identify the banks and sectors that are respectively enforcing and enjoying the benefits of single digit interest rates along with scrutinizing the factors affecting lending and deposit rates in banks. The study observes that most of the loans particularly in consumers' credit, constructions, transportation and trade including green & SME finances are facing much higher than 9 percent interest rate while weighted average deposit rate in the whole banking industry is well below 6 percent. The highest lending rates are observed in consumers' credit and SME financing whereas their rates of NPLs are among the lowest. The average lending rate of the state owned commercial banks is seen to be within the 9 percent limit along with below 3 percent interest rate spread. All other private commercial and foreign banks failed to maintain indicated 3 percent spread mainly due to high lending rates. It could, therefore, be reasonably argued that the surpluses generated from the depositors due to lower deposit rates are mainly shared among banks and borrowers in the form of either higher spread or, in some cases, lower lending rates.

The study identifies a host of factors that have significant influences on lending rates, these include, but not limited to, the cost of fund, rates offered by the peer banks, market rate, demand and supply of loanable funds, regulatory compliances, operating cost, assets-liabilities mismatch, and various risk factors including NPLs. Based on some of these key factors, an attempt has been made to get an estimate of a plausible range of lending rate to see if it is at all possible for banks in Bangladesh to operate viably by charging a single digit (say 9 percent) interest rate on their loans and advances. The estimated result shows a range varying from 6.2 to 13.0 percent interest rate on loans and advances that means a bank with low cost of fund, low operating cost, low capital charge and low risk factors could set a lending at as low as 6.2 percent while a bank with high cost of fund, high operating cost, high capital charge and high risk factors would not be able to set its lending rate less than 13.0 percent. Therefore, the trailing banks must make some visible improvements to reduce their cost of fund through rationalizing high operating cost, capital charge and risk premiums. Banks' group-wise estimate, however, shows that possible lending rates for SCBs, PCBs and FBs as an individual group would be 9.7 percent, 11.0 percent and 7.4 percent respectively against their actual weighted average rates of 7.1 percent, 10.3 percent and 9.1 percent respectively. These estimates, therefore, indicate that the FBs are charging marginally higher rate despite of their ability of making loans at much lower rate while the NCBs, beyond their capacity, are offering loans at well below 9 percent rate.

Furthermore, it has been observed from the survey responses that there are some ongoing initiatives by banks to attain quality asset portfolio, to reduce the amount of classified loan, to augment non-interest earning business, and to avail low cost refinance scheme so that the cost of fund could be reduced and the desired reduction in lending rate can be achieved.

Keywords: Bank, deposit and lending rates, loanable fund, operating cost, non-performing loans. **JEL Classification**: G21, E43, E51.

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1. Introduction

The Bangladesh economy is on a sustained, steady trend of around six percent average annual GDP growth rate for more than a decade, with the lowest growth volatility in South Asia as well as many other emerging economies. Economic growth averaged at 6.6 percent during FY 2010-2018 reaching a record high 7.86 percent in FY2018. Resilience of the domestic economy over years amid repeated episodes of natural calamities and external shocks has provided the markets and entrepreneurs a predictable policy environment of low uncertainty. Global mega lenders are now considering Bangladesh as the next hotspot for investment in infrastructure, energy, housing, education, and technology.

Bangladesh is a developing country and aspires to become a middle income country by 2021; the acceleration of growth is needed in every sphere in the economy. Central Bank has a crucial role to play in making this vision come true through ensuring an effective policy that espouses growth generating economic activities while maintaining price and exchange rate stability. For robust and sustainable economic growth, investment plays a pivotal role in any economy. Economic policy makers often adopt investment stimulating policies to achieve the necessary level of economic growth. Investors generally borrow money from financial institutions to meet up their investment demand. The money borrowed from financial institutions for investment purposes is highly sensitive to interest rate. In fact, many studies underline interest rate as one of the key factors that influence investment profoundly. The interest rate is also the primary concern for Bangladeshi investors to take their investment decision.

The movement of interest rate depends on supply and demand of loanable fund in the market. High interest rate is considered to be detrimental in attracting investment. Acknowledging the importance of higher investment to bolster the economic growth, Bangladesh government and policy makers have recently urged to private bank owners to bring down the interest to single-digit to boost investment and economic activities in Bangladesh. In this backdrop, Bangladesh Bank has recently reduced the CRR to 5.5 percent for commercial banks on bi-weekly average basis from 6.5 percent to ease-up the liquidity condition in the money market. The reduction in the CRR is likely to give some cash-starved private banks required funds for meeting their customers' requirements. Along with this fresh injection of money through the reduction in the CRR, the government has also decided to allow state agencies to deposit 50 percent of their funds with private banks, up from the existing ceiling of 25 percent, to tackle any liquidity stress in the banking sector.

In response to the government call, the banking community agreed to act upon reducing lending rate to single digit. Hence, the objective of the current study is to have a reality check if the current move of single digit interest rate is viable through examining the key factors in determining the lending and deposit rates in Bangladesh economy. The study also intends to highlight the banks' initiatives to bring down the interest rate into single digit. Finally, the paper makes an attempt to provide further insights for designing appropriate policy to influence the lending rate congenial to higher investment and economic growth in days ahead.

The rest of the paper is organized as follows: Section 2 discusses the theoretical background of interest rate determinations; Section 3 provides a brief literature review related to this study; Section 4 presents an analysis of the interaction between investment and lending rate; Section 5 highlights banks' responses to the questionnaire - describing recent trends of bank's credit disbursement and it's recovery, outstanding amount, NPL rate and interest rates; identifying factors affecting the lending and deposit rates in Bangladesh including bank's initiatives to reduce the lending rate to single digit; Finally, Section 6 summarizes the findings of the paper along with some concluding remarks.

2. Determination of Interest Rate on Loans: Theoretical Perspective

The empirical literature often adopts both macro and bank-specific components to analyze the banks' interest rates setting behavior at the micro level. The Keynesian theory of liquidity preference, Fisher's model and Commercial bank balance sheet channel are the main basis for adoption of those components in interest rates determination. The recent contemporary literature assumes that banking industry operates in an oligopolistic market structure where the bank does not act as a price taker but sets its loan price taking into account the demand for loans and deposits.

According to the classical loanable funds and Keynesian theory, the overall economic activity (indicated by the GDP of a country) is a key to determine the banks' interest rate. The interest rate on loans depends positively on GDP as sound economic situations upsurge the number of projects becoming profitable in terms of expected net present value vis-à-vis augment the demand for credit (Kashysap et al., 1993). However, Melitz and Pardue (1973) inferred that credit demand is positively influenced by only the boosting in permanent income rather than the transitory portion of income. On the other hand, Gambacorta (2008) pointed out a rise in the money market rate surges the opportunity cost of other forms of financing (i.e., bonds), making lending more attractive. This mechanism can also increase the loan demand and consequently raises the interest rate on credit. He also noted that deposit rate is negatively associated with real GDP as the higher level of income increases the demand for deposits; conversely, diminishes the incentive for banks to set the higher rate.

The Fisher relationship stated that the interest rate is proportional to change in an expected rate of inflation. However, Feldstein and Eckstein (1970) noted that Fisher's precise conclusion of

proportional change may not hold in an economy due to a variety of institutional factors. In addition, monetary policy changes can also have a direct influence on determining bank interest rates. A monetary tightening (easing) determines a reduction (increase) in reservable deposits and an increase (reduction) in market interest rates. This mechanism has a positive effect on bank interest rates through the traditional interest rate channel. The dealership model by Ho and Saunders (1981) postulated that lending and deposit rates are positively influenced by the high volatility of the money market rate. They stated that the lending rate should be more affected by the call money rate than that on deposits rate which indicates a positive association between interest rate volatility and the spread.

Moreover, bank-specific characteristics such as size (logarithm of total assets), liquidity (cash and securities over total assets) and capitalization (excess capital over total assets), the ratio between deposits and bonds plus deposits, the ratio between long-term loans and total loans are also considered to determine the interest rates. Gambacorta (2008) stated that the intermediation costs such as screening, monitoring, and branching costs have a positive influence on the lending rate on credits and a negative effect on deposits. In addition, the lending rate is also sensitive to the riskiness of the loan portfolio; banks that invest in riskier projects will have a higher rate of return to compensate the higher percentage of non-performing loans that have to write off.

3. Literature Review

The empirical literature determines the bank's interest rate setting behavior depending upon a host of factors as per conventional theories and practices. Edwards and Khan (1985) was developed a model combining liquidity preference approach, Fisher relationship and uncovered interest parity to analyze the determinants of the interest rate in semi-open economies. They mentioned that interest rates in an open economy are likely to be determined through the uncovered interest parity channel, while interest rates in a closed economy are mainly influenced by internal factors such as GDP, money stock and expected inflation. They opined that interest rates in a semi open economy can be the combination of weighted average of the interest rates in open and closed economies. They stated that whether the internal or the external factors could still affect the domestic interest rate indirectly when trade account is fully open but the capital account is completely closed. They studied determination of interest rates for two countries such as Colombia (a small semi-open economy) and Singapore (a small open economy) and found that terms of shock can result in changes in real income and prices, which will affect the domestic demand for credit vis-à-vis influence the equilibrium interest rates.

Dua and Pandit (2002) examined the determinants of interest rates in India in the post-reform period combining both domestic and external factors. They argued that both domestic and external factors are determining the movement of domestic real interest rates. The real money supply, real government expenditure, foreign interest rate, forward premium and inflation rate Granger caused the domestic real interest rate. Similarly, Asamoah and Adu (2016) tried to find the determinants of the bank lending rate in Ghana using annual time series data from 1970 to 2003. They found that the bank lending rate is positively influenced by nominal exchange rate and monetary policy rate, while it is negatively associated with fiscal deficit, real GDP and inflation in the long run. They observed that monetary policy rate and the exchange rate, by far, show strong contemporaneous effects on the average bank lending rate in Ghana.

Kim and Shi (2018) investigated the determinants of two key benchmark interest rates in China using ordered Probit models for quarterly frequency data from 1987 to 2013. They observed that both lending and deposit rates setting behavior are well explained by the changes in inflation and in money growth rate. However, output gaps and the exchange rate appreciation play negligible and insignificant roles in determining revision decisions on these two interest rates. Apart from these monetary, fiscal, exchange rate policies some recent literatures (Villalpando and Guerrero (2007); Gambacorta (2008); Fungacova and Poghosyan (2011); Apergis and Christou (2015)) have given important focus on bank specific features such as bank size, bank liquidity, excess capital, intermediation costs, management efficiency, NPL rate to analyze the bank's interest rates setting behavior.

Villalpando and Guerrero (2007) tested the bank lending rate setting behavior considering 13 banks of Mexico for the quarterly sample from the periods 2001-2006. They obtained a negative relationship between the total loan participation and the loan rate, i.e., banks with a large loan portfolio charge lower loan rates. Therefore, they opined out that small banks tend to charge higher loan interest rates than large banks in Mexico. They also incorporated several bank efficiency indicators in their model where efficiency was found to be statistically insignificant to determine the loan rates during 2001-2006 in Mexico. However, Gambacorta (2008) found that bank efficiency diminishes the interest rate on loans and surges that of deposits while he analyzed interest rate determination behavior of 73 banks in Italy. He also stated that interest rate on loan is positively influenced by the bad loan in Italy. It is worth to note that this is in line with the standard result as when banks invest in riskier projects ask for a higher rate of return to offset the credit risk. He also observed that heterogeneity in the pass-through on the interest rate on current accounts depends on banks' liability structure. However, bank size is never relevant to determine interest rate in Italy.

Fungacova and Poghosyan (2011) analyzed the interest rate margin determinants using unique bank-level data covering Russia's entire banking sector for the 1999-2007 period. In their analysis, they used random effect model to identify the interest margin determinants in the banking sector with a particular emphasis on the bank ownership type. They observed that market structure, credit risk, liquidity risk and size of operations differs to determine margin across state-controlled, domestic-private and foreign-owned banks. However, operational costs and risk aversion are not sensitive to determine margin in Russia across ownership groups.

Younus et al. (2014) tried to identify the determinant of lending rate in Bangladesh. They found that deposit rates, inflation, non-performing loans and both 3 & 5 year NSD certificate rates are significantly influencing the lending rate whereas private sector credit and policy rate does not have any effect on the lending rate in Bangladesh. Similarly Kayum (2016) stated that Banks' lending rate affects the repo rate significantly in the positive direction but the repo rate does not affect lending rate in a significant way in Bangladesh.

4. Interaction between Investment and Lending Rate

The relationship between real gross investment and real lending rate is depicted by Figure-1. It is shown that the movement of real lending rate was stable whereas real gross investment growth rate was significantly swing ups and downs in Bangladesh economy during 2000-16.



Both the investment and lending rate were shown downward trend during 2000-03. But the movement of investment growth was upward and downward and reached at pick in 2006 and afterwards came down at the lowest point in 2009 while interest rate was stable around 5-6 percent. The similar pattern of interaction of these two variables was observed during 2010-2013 in the economy. Afterwards, we observe a significant negative relationship between real gross investment and lending rate that is lending rate was decreasing (increasing) conversely investment growth was increasing (decreasing) in the economy. However, we observe a negative movement between real private investment growth and lending rates during 1995-2016 in

Bangladesh economy (Figure 2). The figure shows that when lending rate increases (decreases) therefore the private investment rate decreases (increases) as expected.



Although two graphs indicate the direction of the relationship between lending interest rate and investment, the magnitude and stability of the relationship cannot be confirmed. Therefore, we estimated a simple linear regression model of investment and interest rate relationship in the following section.

4.1 Model Specification

Unlike other countries in the world, there are few studies estimating the interaction between investment and interest rate in the context of Bangladesh. Hence, we intend to estimate the direction and the magnitude of investment and interest rate relationship using econometric technique.

The investment expenditure function initially can be expressed as follows:

Where, t denotes time (1, 2, 3...N), I=real gross investment spending, RL=real interest rate on lending, Y=real GDP (Growth rate), x=exchange rate, ε =error term.

Similarly, private investment function can be written as

Where, PI = real gross private investment. Yearly data has been collected from secondary sources such as World Development Indicators (WDI) of World Bank, Bangladesh Economic Review of Ministry of Finance, Bangladesh. We covered the period from 1994 to 2016.

4.2 Empirical Results

Table 1 summarizes the estimated results of gross real investment equation and private investment equation. It shows that real lending rate negatively affects both real gross investment and private investment significantly. On average 1 percent increase in real lending rate reduce

the real gross investment growth by about 1.05 percent and private investment by 0.76 percentage points. On the other hand, exchange rate depreciation affects investment positively. On average 1 percent depreciation in exchange rate lead to 0.88 percentages point increase in gross investment and 0.73 percentage point in private investment.

Table 1: Estimated Results of Interaction between Real Investment and Lending Rate										
Dependent Variables	Independent Variable for two Alternative Equations									
Dependent variables	(i) Real Gross Investment	(ii) Real Gross Private Investment								
Deel Londing Data	-1.05***	-0.76**								
Real Lending Rate	(0.01)	(0.04)								
Des1 CDD	-0.74	-0.75								
Real GDP	(0.47)	(0.44)								
Euchenge Date	0.88***	0.73***								
Exchange Kate	(0.00)	(0.00)								
Genetant	18.36***	16.95**								
Constant	(0.01)	(0.02)								
Note: P-value in parenthesis;										
***statistically significant at	1%; ** statistically significant at 5%	level of significance								

5. Banks' Responses to the Questionnaire

During 05-26 July 2018, primary data were collected from all the schedule banks operating in the country through a structured questionnaire. Following section summarizes the information obtained from banks. Total 58 scheduled banks are operating in the financial market of Bangladesh of which 6 banks are State-owned Commercial Bank (SCBs), 2 banks are Specialized Bank (SBs), 33 banks are Private Commercial Banks (PCBs), 8 banks are Islami Banks (IBs) and 9 banks are Foreign Commercial Banks (FBs). Relevant data and information from 56 banks² were collected. Based on the surveyed data, a brief overview of the bank's sectorwise loan disbursement and its recovery, outstanding amount of loan, gross NPL rate and interest rates is discussed below:

5.1. Credit Disbursement

Table 2 presents the sector-wise credit disbursement in 2016 and 2017 respectively. It is observed that banks disbursed Tk. 1827.3 billion in industrial sectors which was around 29.63 percent of total credit disbursement in 2016. This share was somewhat increased to around 30.25 percent in 2017. The trade & commerce sector received the second largest amount of credit from the banks followed by the SME financing in both two years. In total, banks disbursed approximately 72.45 percent of total credit to these three sectors in 2016 which was slightly higher (about 73.09 percent) in 2017. This result is plausible as the contribution of industrial and manufacturing goods to exports earning is surging in recent years. Moreover, Bangladesh economy is experiencing rapid economic growth where industry's share on GDP is also in rising

² Excluding Shimanto and Probashi Kallyan Banks as they started their operations very recently.

trend. As a result, this rising trend of manufacturing's share on GDP entails huge funding in the aforementioned three sectors. Within the bank groups, private commercial and islami banks were mainly provided credit to these three sectors (Appendix A).

On the other hand, credit disbursement in the agriculture, construction, consumer and green finances were varied between 3-4 percent of total loan in 2016 and 2017 respectively. In case of agriculture credit, the lion share of loan was disbursed by the private commercial and specialized banks. Though the number of specialized bank is only 2, but they are mainly entitled to provide agri-credit to farmers to mitigate their financial need and to augment the agri-productivity in Bangladesh. Private commercial and islami banks disbursed the large share of their credit to the rest of the sectors in 2016 and 2017 (Appendix A).

5.2. Loan Recovery and Outstanding Amount

In case of recovery and outstanding amount of loan, the study finds similar trend in line with the credit disbursement in 2016 and 2017. The lion share of recovery and outstanding amount of loan was observed in industry, commerce & trade and SME financing as much amount of loan went to these three sectors. However, loan recovery share was somehow lower in case of construction and consumer financing as compared to loan disbursement to these two sectors. The survey data reveal that the credit recovery and outstanding amount of loan shares trend in each sector by the bank groups were similar with the share of credit disbursement (Appendix A).

5.3. NPL Rate

Table 2 delineates that the average gross NPL rate was around 11.54 percent and 11.41 percent in 2016 and 2017 respectively in the banking industry of Bangladesh. The average gross NPL rate was high in trade & commerce sector (11.49 percent & 10.63 percent in 2016 and 2017) followed by the term loan case. Although the amount of loan disbursement in transport sector was the lowest as compared to other areas, but the rate of bad loan was the third highest in terms of percentage of total loan in that area during the reference periods.

The study finds that although the lion share of credit disbursement was given by the private commercial banks, however, their average gross NPL rate was relatively lower in most of the sectors as compared to the state owned banks (Appendix A). It is observed that around 21.96 percent of industrial credit by the state owned commercial banks became classified in 2016 which was 24.59 percent in 2017. Similarly state owned commercial bank's bad loan share was higher in other of areas such as transport, trade & commerce, SME financing etc. Overall, the state owned banks report that about 30.4 percent and 31.4 percent of their loan was classified in 2016 and 2017 respectively. The NPL rate of specialized banks was also higher during the reference periods. Overall, about 13.8 percent and 15.1 percent loan of islami banks became classified in 2016 and 2017 respectively. The NPL rate of specialized banks was mainly comes from

industrial and trade & commerce sectors. On the other hand, the NPL rate of foreign banks was mainly driven by the poor performance of National Bank of Pakistan and State Bank of India.

5.4. Lending and Deposit Rates

The weighted average lending rate in the banking industry was 9.54 percent in 2017 which was lower by 0.72 percentage point than 10.25 percent in 2016. The study finds that the highest average lending rate was 12.32 percent & 11.43 percent in case of consumer financing in all the sectors in 2016 and 2017 respectively. The main reason of this higher consumer financing is driven by credit card uses. Moreover, the lending rate was above the 10 percent in case of construction, SME financing in both 2016 and 2017. On the other hand, private commercial and islami banks were mainly charged the higher lending rate as compared to that of state owned, specialized and foreign banks. Industry's weighted average deposit rates, on the other hand, decreased from 5.46 percent in 2016 to 5.12 percent in 2017 (Appendix A).

Looking at the total volume of lending, it is the private commercial banks category that disbursed major share of credit in 2016 and 2017 with relatively lower NPL rate as compared to the other bank categories. However, their weighted average lending rate was higher than that of other banks.

5.5. Interest Rate Spread

As per the declaration of 9 percent lending and 6 percent deposit rates, the interest rate spread should be around 3 percent. Latest available data (Table 2), however, does not seem to be supporting this argument. Despite their high operating cost and offering of cost-free government services, the only exception is the state owned commercial banks. All other private commercial and foreign banks failed to maintain indicated 3 percent spread mainly due to high lending rate. As of August 2018, the interest rate spread in the banking industry for all banks stood at 4.27 percent, while the spread for SCBs, SBs, PCBs, and FBs appeared to be 2.69 percent, 3.24 percent, 4.36 percent and 6.85 percent respectively. This is due to the fact that most of the private commercial banks' loans particularly in consumers' credit, construction, transportation and trade including green & SME finances are facing much higher than 9 percent rate while weighted average deposit rate in the banking industry is well below 6 percent.

Table 2: Interest Rate Spread in Bangladesh (as on August 2018)											
Banks/Group	Lending Rate	Deposit Rate	Interest Rate Spread								
All banks	9.63	5.36	4.27								
State Owned Commercial Banks (SCBs)	7.06	4.37	2.69								
Specialized Banks (SBs)	8.91	5.67	3.24								
Private Commercial Banks (PCBs)	10.31	5.95	4.36								
Foreign Banks (FBs)	9.11	2.26	6.85								
Source: Bangladesh Bank.			·								

5.6. Factors Affecting Lending and Deposit Rates in Bangladesh

Although banks generally fix their interest rate based on some specific economic and financial factors across the globe, these factors can vary from bank to bank and from country to country. Hence, to retrieve the actual practices of Bangladeshi banks in case of determining the lending and deposit rates, banks were asked to list the factors that they consider while setting the lending and deposit rates. In response to this question, banks have highlighted the number of factors that they consider while setting the lending and deposit rates in Bangladesh. The study finds that most of the banks operating in the country consider the cost of fund, peer banks rate/market rate, market competition or demand and supply of loanable fund, regulatory compliance, operating cost, assets-liabilities condition, credit risk, monetary policy stance of BB, money market situation, economic outlook and inflation movement, borrower's financial strength, NPL position etc. while setting interest rate on loans /advances and deposit. Moreover, advance to deposit ratio, spread, yield on government securities etc. are significant factors affecting the deposit rates. Apart from these major factors, some banks have given importance on profit targets of management and their goal towards the expansion and contraction of the balance sheet, credit policy, non-interest income, tenor of lending & deposit, budget financing, bank projected cash flows, and appropriate deposit mix to set their lending and deposit rates.

The priority factors that determine interest rates vary across the bank groups in Bangladesh which is presented orderly in Table 3 & 4. The Table 3 delineates that the cost of fund is the most common factor to set lending rate as the majority of the banks (around 55 percent) focused on it. This factor is highly reported by the state owned commercial banks (SCBs) and Islami banks (IBs) as compared to other types of banks. Although around 83 percent SCBs reports the name of this factor however this is not the first priority factor to determine the SCBs' lending rate (Table 4). Though most of the banks consider peer banks rates to fix the lending and deposit rates, but its rank varies across the bank groups in Bangladesh. Overall banks give this as a second priority factor to set interest rates while foreign banks do not give it that much importance for their interest rate setting as compared to the rest of the bank groups in Bangladesh economy. The essence of this result is that banks are operating in a competitive environment in Bangladesh so they cannot set their rate irrationally to keep themselves competitive in the entire financial market. The study finds that specialized banks do not concern about the industry interest rate. This result is plausible as they are mainly entitled to disburse credit to agricultural sectors. Generally, their rate is set by the government and regulatory body at the beginning of the fiscal year when the agri-credit disbursement target is fixed-up.

On the other hand, only 34 percent banks report that they consider monetary stance of BB to determine their interest rate; however, it is one of the key priority factor for banks in Bangladesh, especially to SCBs' and PCBs', to decide the interest rates. In addition, the regulatory

compliance, credit risk, liquidity position of banks, operating expenses are plotted in the top priority factors by the banks to determine the rates in Bangladesh economy. The maturity gap between asset-liabilities is an important element for the islami banks; foreign banks and state owned commercial banks while A/D ratio is mainly vital factor for the foreign and specialized banks in Bangladesh. Country's inflation outlook is a key factor to all the domestic commercial banks to set the interest rates. Table 3 depicts that only few numbers of banks mention about customer's financial strength, economic outlook, NPL rate, interest rate spread, yield on government securities/risk free rate and in similar fashion those factors importance are less to the banks to determine the interest rates (Table 4). Based on the factors identified by the banks, an attempt has been made in the later part of this sub-section to get estimate of a plausible range of lending rate to see if it is at all possible for banks in Bangladesh to operate viably charging a single digit (say 9 percent) interest rate on their loans and advances.

Table 3	able 3: Factors Affecting the Lending and Deposit Rates in Bangladesh												
SI. No.	Factors Name	All Banks	SCBs	SBs	PCBs [#]	FBs	IBs						
1	Cost of fund	55%	83%	50%	52%	33%	71%						
2	Peer banks interest rate	55%	83%	-	59%	56%	29%						
3	Market competition/demand and supply of loanable fund	53%	33%	50%	55%	56%	57%						
4	Regulatory compliance/cost (CRR/SLR)	47%	33%	50%	48%	56%	43%						
5	Operating expenses and administration cost	38%	17%	50%	41%	33%	43%						
6	Liquidity risk-mismatch between asset and liabilities/liquidity management/maturity gap	36%	-	-	45%	33%	43%						
7	Risk associated with lending/credit risk/default risk	36%	17%	-	38%	56%	29%						
8	Monetary policy stance (repo rate/reverse repo rate/credit growth/money supply)	34%	50%	50%	41%	11%	14%						
9	Liquidity position of own bank/industry	32%	17%	-	28%	67%	29%						
10	Advance to deposit ratio (A/D ratio)	28%	33%	50%	28%	44%	-						
11	Inflation Outlook	26%	17%	-	34%	11%	29%						
12	Overall money market situation/ trend/call money rate	32%	83%	-	17%	56%	29%						
13	Customer's financial strength (loan pay back history)/customer's risk rating	23%	-	50%	28%	22%	14%						
14	Review of economic outlook	21%	17%	-	28%	-	14%						
15	Cost of capital/cost of allocated capital	17%	17%	-	21%	-	29%						
16	NPL Position of the bank	17%	17%	50%	21%	11%	-						
17	Interest rate spread	15%	17%	-	10%	11%	43%						
18	Yield on government securities/risk free rate	13%	-	-	21%	-	14%						
Source: # Exclu	Source: Author's Compilation from Survey data by the Governor Secretariat, Bangladesh Bank # Excluding islami banks												
	High no. of bank reported N	Aedium no. of ba	ink reported		Less no. o	of bank rep	orted						

Table	4: Priority Factors Ranked by Bank Groups						
Sl. No.	Factors Name	All Banks	SCBs	SBs	PCBs [#]	FBs	IBs
1	Cost of fund	1	2	1	1	1	1
2	Peer banks interest rate/industry rate	2	1	-	2	7	4
3	Market competition (demand and supply of loanable fund)	3	4	4	3	5	2
4	Monetary policy stance (repo/reverse repo/credit growth/money supply)	4	3	2	4	11	-
5	Regulatory compliance/cost (CRR/SLR)	5	5	1	6	4	5
6	Risk associated with lending/credit risk	6	-	-	5	2	-
7	Liquidity position	7	7	-	9	1	-
8	Administration cost	8	-	2	7	7	3
9	A/D ratio	9	-	2	10	3	-
10	Liquidity risk mismatch between asset and liabilities/liquidity management/maturity gap	10	7	-	12	6	2
11	Country's inflation rate	11	6	-	8	10	7
12	Overall money market situation/ trend/call money rate	12	-	-	7	-	-
13	Interest rate spread	13	5	-	14	-	6
14	NPL Position	14	6	3	15	8	-
15	Borrower Past history/loan pay back record	15	-	2	16	9	-
16	Economic outlook	16	-	-	11	-	-
17	Deposit mix	17	5	-	15	11	-
18	Yield on government securities/risk free rate	18	-	-	13	-	-
19	Expected loss	19	-	-	18	-	5
20	Expected rate of ROE/profitability	20	-	-	17	-	-
Source islami	Author's Compilation from Survey data by the Gover banks	mor Secretar	riat, Bang	gladesh	Bank; # E	xcludin	g

The correlation between interest rate and some bank specific indicators are presented in Table 5. This table is based on data from almost all banks for the year 2016 and 2017 respectively. We observe that the correlation coefficient between lending rate and deposit rate is positive and statistically significant. Similarly, the lending rate is also positively associated with the interest rate spread, advance-deposit ratio and return on asset in banking industry of Bangladesh. But surprisingly NPL correlates the lending rate negatively in Bangladesh economy. On the other hand, the correlation coefficient of SLR expenses, CRR expenses and Liquidity position of the bank posses an expected sign but those coefficients are not statistically significant.

	Lend_rate	Dep_rate	Spread	NPL	ROA	Bank_br	ADR	CRR_ex	Liquidity	SLR_ep
Lend_rate	1.00									
Dep_rate	0.48***	1.00								
Spread	0.62***	-0.39***	1.00							
NPL	-0.68***	-0.004	-0.71***	1.00						
ROA	0.20**	-0.24***	0.42***	-0.54***	1.00					
Bank_br	-0.01	0.025	-0.03	0.15	-0.45***	1.00				
ADR	0.25***	0.56***	-0.24***	-0.09	0.11	-0.35***	1.00			
CRR_exp	0.02	-0.07	0.08	0.006	-0.19**	0.78***	-0.27***	1.00		
Liquidity	-0.08	-0.13	0.03	0.16*	-0.10	0.71***	-0.49***	0.80***	1.00	
SLR_exp	0.02	-0.12	0.13	0.02	-0.10	0.74***	-0.37***	0.92***	0.87***	1.00
Source: Au	thor's calcula	tion based o	n data from	Bangladesh	bank					
*** statistic	ally significa	int at 1%; **	⁴ statistically	significant	at 5%; * stat	tistically sig	nificant at 1	0%.		

Table 5: Correlation Matrix between Interest Rate and Some Bank Specific Indicators

5.7. Hypothetical Estimation of Lending Rate on Bank Loans

Based on some assumptions and available information, we have calculated a hypothetical interest rate band that a bank can charge if all other things remain constant. The calculation of the hypothetical lending rate may be expressed through the following equations:

$$\label{eq:linear} \begin{split} LR_{High} = & DR_{High} + OC_{High} + ROA_{High} + CC_{High} + RP_{High} - \dots \end{split} \tag{iii} \\ LR_{Low} = & DR_{Low} + OC_{Low} + ROA_{Low} + CC_{Low} + RP_{low} - \dots (iv) \end{split}$$

Where, LR=Weighted Average Lending Rate, DR=Weighted Average Deposit Rate; OC=Operating Cost, ROA=Return on Asset as proxy for profitability, CC=Capital Charge Rate and RP = Risk Premium.

Highest and lowest possible values of the deposit rate, operating cost rate, return on asset, capital charge rate, and risk premiums are used to come up with a range of possible lending rate by banks. Banks' group-wise information and estimates of highest and lowest average values of the above variables used in equations (iii) and (iv) generate a band of lending rates ranging from 6.2 to 13.0 percent (Table 6).

Tabl	Table 6: Hypothetical Estimate of Lending Rate on Bank Loans in Bangladesh												
D	DR		OC		ROA		CC		P	Lending Rate			
1	2	3	4	5	6	7	8	9	10	11=1+3+5+7+9 12=2+4+6			
Low	High	Low	High	Low	High	Low	High	Low	High	Low	High		
2.5	5.6	2.0	2.7	0.2	2.2	1.0	1.5	0.5	1.0	6.2	13.0		
Sourc	Source: Bangladesh Bank and Author's Estimation												

Based on the equation (iii) & (iv) mentioned above, hypothetical lending rates for each bank group are estimated (Table 7). It shows that possible lending rates by SCBs, PCBs and FBs as an individual group would be 9.7 percent, 11.0 percent and 7.4 percent respectively while average

deposit rates for all groups are well below 6 percent. These estimates, therefore, confirm that charging single digit interest (say 9 percent) on lending may not be possible for most of the banks unless there is significant improvement is achieved to mitigate operating cost, capital charge and risk premiums.

Table 7: Estimation of Bank-Group Wise Lending Rate											
Bank-Groups	DR	OC	ROA	CC	RP	Lending Rate					
State Owned Commercial Banks (SCBs)	4.4	2.6	0.2	1.5	1.0	9.7					
Private Commercial Banks (PCBs)	5.3	2.5	0.9	1.3	1.0	11.0					
Foreign Banks (FBs)	1.7	2.0	2.2	1.0	0.5	7.4					
Source: Bangladesh Bank and Author's Esti	mation										

5.8. Banks' Initiatives to Reduce the Lending Rate to Single Digit

In response to the recent initiative of reducing deposit and lending rates to 6 and 9 percent respectively, some visible developments are observed particularly in case of deposit rates. Although the desired reduction in lending rate is yet to witness, this study comes across some deliberate initiatives by banks to bring up the expected outcome. Some of the initiatives that banks are pursuing to reduce the lending rate to a single digit are as follows:

Decreasing the Cost of Fund: This study finds that the cost of fund is one of the vital factors in determining interest rate. According to the principle of the cost theory, if the cost of fund is high, the price of that fund should be higher. With a view to reducing the existing lending rate, most of the banks report that they are reviewing their deposit products to collect low cost deposit vis-a-vis to diminish the cost of fund. Moreover, some banks decide to improve CASA³ deposit scheme and to reduce term deposit rate to bring down the cost of fund and the lending rate.

Decreasing Classified Loan: The collected data reveal that some banks give priority to ensure quality in asset portfolio and quality in credit growth to reduce the amount of classified loan. As a result, this can decrease the provision against the classified loan and, thereby, increase the flow of loanable fund to soften the lending rate.

Enhancing Institutional Efficiency: The study finds that some banks opt to enhance institutional capacity and efficiency through better, faster and secure use of information and technology. As a result, they are expecting to reduce their administrative and operational expenses so that they can trim down the lending rate towards desired direction.

³A current account savings account (CASA) is aimed at combining the features of savings and checking accounts to entice customers to keep their money in the bank by paying very low or no interest on the current account. Retrieved from: https://www.investopedia.com/terms/c/current-account-savings-account.asp.

Reducing the Dependency on Interest Income: Some banks decide to proliferate their nonfunded business and fee/commission based business to reduce the dependency on interest income.

Reduction of Lending Rate in Priority Sectors: Some banks affirm that they have already brought down their lending rate to single digit in some priority sectors such as agriculture, term loan to medium & large industries, working capital financing for small, medium & large industries, commercial lending, housing finance, etc. Gradually, all other sectors might enjoy the benefits of single digit interest rate in near future.

BB Refinance Scheme: The study finds that some banks plan to avail various BB refinance scheme to offer single digit lending rate in some specific industries and sectors.

6. Summary and Concluding Remarks

The main objective of this study is to identify the banks and sectors that are respectively enforcing and enjoying the benefits of single digit interest rates along with scrutinizing the key factors affecting lending and deposit rates in banks of Bangladesh. Survey based data/ information collected during 05-26 July 2018 from banks along with some secondary data are used for this study. The study observes the following key findings:

- 1. It is observed that most of the loans particularly in consumers' credit, construction, transportation and trade including green & SME finances are facing way higher than 9 percent rate while weighted average deposit rate in banking industry is well below 6 percent. It could, therefore, be reasonably argued that the surpluses generated from the depositors due to lower deposit rates are mainly shared among banks and borrowers in the form of either higher spread or, in some cases, lower lending rates.
- 2. Most of the banks operating in the country consider the cost of fund, peer banks rate and market rate, market competition and demand and supply of loanable fund, regulatory compliance, operating cost, assets-liabilities condition, credit risk, monetary policy stance of BB, money market situation, economic outlook and inflation movement, borrower's financial strength, NPL position etc. while setting interest rate on loans or advances and deposit. Moreover, advance to deposit ratio, spread, yield on government securities, etc. are significant factors affecting the deposit rate.
- 3. Around 55 percent banks consider cost of fund and peer banks' interest rates when they set their interest rate on loan and advances.
- 4. The major share of credit was mainly disbursed by the private commercial banks and islami banks operating in the country during 2016-2017. But their NPL rate was lower as compared to the other categories of banks. The lending rate charged by these two groups of banks was higher than that of other groups of banks.

- 5. Some bank specific indicators such as deposit rate, interest rate spread, NPL rate, return on equity, and advance-deposit ratio significantly influence the banks in setting their lending rates.
- 6. In order to bring down the current lending rate, banks are taking number of policies such as: to bring down the cost of fund, to ensure quality in asset portfolio and quality in credit growth to reduce the amount of classified loan; to augment non-interest earning business; to offer single digit to some priority sectors; to avail BB refinance scheme.
- 7. The study finds that with the exception of SCBs all other private commercial as well as foreign banks failed to attain the expected interest rate spread of 3 percent commensurate to the targeted 6 percent deposit and 9 percent lending rates mainly due to high lending rates.
- 8. Based on some of these key factors, an attempt has been made to get an estimate of a plausible range of lending rate to see if it is at all possible for banks in Bangladesh to operate viably charging a single digit (say 9 percent) interest rate on their loans and advances. The estimated results show a range for loans varies from 6.2 to 13.0 percent that means a bank with low cost of fund, low operating cost, low capital charge and low risk factors could set a lending at as low as 6.2 percent while a bank with high cost of fund, high operating cost, high capital charge and high risk factors would not be able to set its lending less than 13.0 percent. These estimates, therefore, confirm that charging 9 percent interest rate on their lending may not be possible for most of the banks unless there is significant improvement is achieved to mitigate operating cost, capital charge and risk premiums.
- 9. Banks' group-wise estimate shows that possible lending rates for SCBs, PCBs and FBs as an individual group would be 9.7 percent, 11.0 percent and 7.4 percent respectively against their actual weighted average rates of 7.1 percent, 10.3 percent and 9.1 percent respectively. These estimates, therefore, indicate that the FBs are charging marginally higher rate despite of their ability of making loans at much lower rate while the NCBs, beyond their capacity, are offering loans at well below 9 percent rate.

In sum, it is observed that private commercial and islami banks are the main player in terms of credit disbursement in financial markets of Bangladesh. However, their lending rate is higher as compared to other form of banks operating in the economy. So to bring down the lending rate in single digit substantially, appropriate policy measures are needed to diminish the tendency of setting lending rate at double digit by those banks. Some policy initiatives, in general, may be considered to reduce the lending interest rate that includes:

- Steps to improve managerial efficiency to reduce operating cost.
- Steps to ensure high credit quality to reduce non-performing loans.
- Steps to reduce risk factors related to market, credit and IT related risks.

- Steps to establish good governance in the banking sector to reduce financial scams and financial malpractices in the banking industry.
- Steps to ensure a healthy liquidity condition maintaining required flow of loanable funds.
- Steps to set some refinance lines of credit for various priority sectors of the economy.
- Steps to encourage banks to lend more to the productive sectors to contribution to the economy's income generating activities and to reduce default risks.
- Finally, steps to ensure proper counseling and monitoring by central bank and by commercial banks themselves are required to tackle the factors that make difficult to reduce lending rates.

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Appendix A

Table 1:	ble 1: Bank-wise Loan disbursement, Outstanding Amount of Loan, NPL and Weighted Average Lending Rates in Bangladesh																			
	Agric	ulture	Indu	ıstry	Constr	ruction	Tran	sport	Trade &	Commerce	Consume	er Finance	Green	Finance	SME F	Finance	Otl	ners	Ove	erall
	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017
							B	ank's Lo	an Disburse	ment (in per	centage of t	otal loan in e	each secto	r)						
SCBs	13.0	12.2	2.6	2.8	3.4	2.3	1.0	1.0	3.5	4.4	19.6	18.2	0.4	0.2	5.7	5.4	9.2	8.8	5.0	5.1
SBs	30.8	25.7	0.1	0.1	0.0	0.0	0.0	0.0	0.2	0.2	0.8	0.6	0.0	0.1	0.6	0.6	0.8	1.1	1.3	1.2
PCBs [#]	39.4	41.1	64.1	64.8	72.2	63.5	50.1	58.7	45.9	46.5	59.2	60.7	22.9	19.8	43.4	44.9	78.1	80.5	55.2	55.6
FBs	1.6	3.0	8.9	9.0	0.1	9.5	17.8	6.8	4.0	3.6	9.1	9.7	10.6	9.7	1.0	1.2	2.8	3.6	5.0	5.5
IBs	15.2	18.0	24.3	23.2	24.4	24.7	31.1	33.4	46.5	45.3	11.3	10.8	66.0	70.2	49.3	48.0	9.0	5.9	33.4	32.6
	Bank's Loan Recovery (in percentage of total loan recovery in each sector)																			
SCBs	10.20	11.17	1.62	1.35	1.10	1.40	0.51	1.81	0.91	1.32	8.85	10.53	0.10	0.10	0.81	1.44	6.94	8.01	2.40	2.72
SBs	31.88	29.69	0.49	0.48	0.00	0.00	0.00	0.00	0.22	0.19	1.00	0.95	0.00	0.00	0.13	0.12	1.19	1.77	1.42	1.42
PCBs [#]	32.89	35.32	61.52	61.29	73.06	68.26	30.26	38.54	43.22	46.34	57.32	60.00	16.63	12.59	39.34	37.61	78.08	76.55	52.38	52.23
FBs	2.27	3.20	10.51	10.18	0.15	0.04	52.45	30.46	4.61	4.39	18.78	17.36	16.06	12.35	1.22	1.31	2.84	3.90	6.68	6.04
IBs	22.75	20.62	25.86	26.70	25.70	30.30	16.78	29.18	51.04	47.77	14.05	11.16	67.21	74.96	58.51	59.52	10.94	9.77	37.12	37.59
	Bank's Outstanding Amount of Loan (in percentage of total outstanding loan in each sector)																			
SCBs	29.11	28.23	14.90	12.76	17.47	16.91	20.03	18.72	16.30	16.27	17.04	20.45	1.51	1.17	12.00	12.34	39.50	37.81	18.26	17.48
SBs	41.55	39.56	1.61	1.32	0.00	0.00	0.00	0.00	2.16	1.77	0.19	0.10	0.00	0.11	0.59	0.51	2.95	2.96	3.37	3.01
PCBs [#]	19.87	21.99	60.81	66.80	57.76	58.38	37.63	44.58	47.86	45.86	63.29	62.66	46.29	48.27	47.02	47.39	47.15	48.86	51.37	53.34
FBs	1.72	2.22	4.35	0.76	0.12	0.02	14.48	7.83	2.44	2.05	14.09	12.15	10.82	11.36	1.48	1.58	1.97	2.01	3.36	2.19
IBs	7.75	8.00	18.34	18.36	24.65	24.69	27.85	28.87	31.24	34.06	5.39	4.64	41.38	39.09	38.91	38.18	8.44	8.35	23.63	23.97
		1	1	1	1	•	1	1	T	NPL	Rate	1		0	1	•	1	•	1	
SCBs	7.87	10.84	21.96	24.59	6.1	7.9	16.5	24.6	17.1	17.0	8.1	7.7	0.3	25.8	21.1	22.6	18.9	20.3	30.4	31.4
SBs #	11.36	10.91	14.42	14.00	-	-	-	-	22.9	18.2	28.7	34.6	-	-	13.7	11.9	6.8	5.8	23.0	23.7
PCBs"	1.23	1.32	2.10	2.84	1.0	1.5	4.8	6.9	6.6	4.8	1.2	1.0	3.9	0.9	3.1	4.0	2.8	2.8	5.1	5.4
FBs	12.50	12.50	20.15	15.34	24.4	23.3	35.7	25.0	21.9	23.6	2.8	1.4	0.0	0.0	16.3	14.5	13.2	12.4	16.8	13.1
IBs	0.28	0.34	13.14	13.31	1.4	1.7	1.1	0.7	12.4	13.7	6.7	5.3	1.2	1.2	3.1	3.0	14.2	11.8	13.8	15.1
GGD									Wei	ghted Avera	ge Lending	Rate								
SCBs	8.38	7.71	7.81	7.74	10.3	8.9	7.7	8.9	8.5	8.0	10.6	9.8	7.6	7.3	10.5	10.1	8.3	8.0	10.0	9.1
SBs	8.66	7.90	7.05	6.55	-	-	-	-	6.9	7.1	11.0	9.5	13.0	9.0	6.8	6.5	6.7	5.2	9.3	9.1
PCBs"	9.68	9.05	10.45	9.76	10.7	10.6	11.2	10.1	10.9	10.3	12.7	12.0	10.3	10.2	12.0	11.3	10.1	10.0	11.0	10.1
FBs	8.30	6.92	7.09	6.68	9.0	9.3	6.8	7.3	6.7	6.2	11.5	9.2	8.7	8.9	10.1	10.0	6.4	7.1	7.2	7.1
IBS	10.42	9.34	11.74	10.45	12.1	11.7	11.9	10.9	12.2	11.6	12.8	12.2	10.9	11.0	12.3	11.6	11.6	11.0	11.4	10.6
Note: Ind # Exclud	Author's C lustry incl ing islami	Lompilati ludes tern i banks	on from S 1 loan and	working	a by the G capital fin	nancing	n Secreta	riat, Bang	ladesh Bank											

				(in	Billion	Taka)						
	Lo	an			Outst	anding	NPL	Rate	Weig	ghted	Weig	ghted
Sectors Name	Disburs	sement	Loan R	ecovery	Amount	of Loan	(Gro	oss)	Ave	rage	Ave	rage
	2016	2017	2016 2017		2016	2017	2016 2017		2016	ig Kate	Depos 2016	it Kate
	2010	2017	2010	2017	2010	ll Banks	2010	2017	2010	2017	2010	2017
	190.4	231.7	165.50	188.3	335.3	373.4		I			I	
A) Agriculture	(3.09)	(3.28)	(3.17)	(3.24)	(4.77)	(4.49)	3.96	4.34	9.41	8.59		
B) Industry	1827.3	2135.1	1578.3	1720.0	2182.8	2641.9						
(i+ii)	(29.63)	(30.25)	(30.25)	(29.57)	(31.05)	(31.75)	9.15	9.07	9.72	9.06		
i) Term Loan	461.6	522.8	349.0	366.9	1087.0	1279.3	11.00	10.00	10.00	0.44		
	(7.48)	(7.41)	(6.69)	(6.31)	(15.46)	(15.37)	11.09	10.60	10.30	9.44		
ii) Working	1365.8	1612.3	1229.3	1353.0	1095.8	1362.6	_					
Capital Financing	(22.14)	(22.84)	(23.56)	(23.26)	(15.59)	(16.38)	6.05	7.03	9.72	9.20	5.46	
C) Construction	222.8	256.9	138.7	194.5	492.7	529.5	4.00			10 7 1		
	(3.61)	(3.64)	(2.66)	(3.34)	(7.01)	(6.36)	4.09	4.45	10.74	10.56		5.12
D) Transport	64.3	44.8	67.4	44.8	82.5	85.0	0.00	9.53	10.68	9.95		
	(1.04)	(0.63)	(1.29)	(0.77)	(1.17)	(1.02)	8.29					
E)Trade &	1434.3	1643.1	1208.8	1389.1	1297.2	1530.7	11.40	10.62	10.10	0.57		
Commerce	(23.25)	(23.28)	(23.17)	(23.88)	(18.45)	(18.40)	11.49	10.63	10.10	9.57		
F) Consumer	199.0	253.2	148.4	162.4	313.2	424.4	1.05	2.70	10.00	11.42		
Finance	(3.23)	(3.59)	(2.85)	(2.79)	(4.46)	(5.10)	4.05	3.70	12.32	11.43		
G) Green	241.0	290.6	173.3	194.6	105.7	137.9		0.46	10.11	0.00		
Finance	(3.91)	(4.12)	(3.32)	(3.35)	(1.50)	(1.66)	2.67	3.46	10.11	9.99		
H) SME	1207.3	1380.9	1046.1	1205.0	1415.0	1669.5	7.20	7.66	11 44	10.05		
Finance	(19.57)	(19.56)	(20.05)	(20.71)	(20.13)	(20.06)	7.38	7.66	11.44	10.85	2	
I) Others	781.5	822.2	690.6	718.8	805.0	928.6			0.25	0.00		
	(12.67)	(11.65)	(13.24)	(12.36)	(11.45)	(11.16)	7.83	1.52	9.30	9.32		
Grand Total	6167.8	7058.4	5217.1	5817.4	7029.4	8320.9	11.54	11.41	10.26	9.54		

 Table 2: Sector-Wise Credit Disbursement, Recovery, Outstanding, NPL Rate and Weighted Average Lending and Deposit Rates in Bangladesh

Source: Author's Compilation from Survey data by the Governor Secretariat, Bangladesh Bank Note: Percentage of total in parenthesis; In case of term loan, Working Capital Financing excluded while import and export financing excluded for working capital financing.