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Financial reforms and persistently high bank interest spreads in Bangladesh: Pitfalls in institutional development?

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ABSTRACT

This paper analyzes interest rate spreads and margins in Bangladesh for the period 1990–2008 by applying the Arellano–Bover/Blundell–Bond dynamic panel regression model to a panel of 43 banks. The model has been applied to tackle short-panel bias and endogeneity problems in banking analysis. A high degree of persistency in spreads and margins is observed, which points to inefficiencies of bank management. More specifically, high administrative costs, high non-performing loan ratio, market power, small share of deposits and some macroeconomic factors are found to be the key determinants of persistently high interest rate spreads and margins in Bangladesh. The findings of this study suggest that reforms commenced in the 1990s could not generate adequate competition and efficiency in the financial sector, particularly to drive down the spread in line with the predictions of interest rate literature. This situation in other words indicates pitfalls in institutional development.

1. Introduction

It is widely argued that financial reforms and liberalization that involve decontrolling interest rates, eliminating credit limits and enacting new laws and regulations governing the financial sector should improve efficiency in the intermediation process. The interest rate spread (IRS), i.e., the difference between the weighted average interest rates on loans and deposits, is a key indicator of financial performance and efficiency of the banking sector. The spread is expected to decline over time with liberalization of the financial sector. This proposition is linked to the McKinnon (1973)–Shaw (1973) paradigm that financial liberalization leads to significant improvement of growth prospects. A high spread usually refers to a low deposit rate and a high lending rate that act as impediments to the expansion of financial intermediation by entailing a high cost of borrowing and discouraging savings in the economy. A high spread thus limits investment opportunities and restricts the growth potential of the economy. The conventional view is that financial liberalization and growth usually go together as liberalization increases the supply of loanable funds to the economy through increasing efficiency of the financial sector (Khan & Senhadji, 2000; King & Levine, 1993; Levine, 1997). However, financial liberalization may not lead to the expected outcome unless necessary legal and financial institutions are properly developed (Chinn and Ito, 2006).

Bangladesh carried out extensive financial sector reforms during the 1990s. Financial liberalization measures adopted include lifting barriers to entry of foreign and private commercial banks, decontrolling interest rates and credit disbursement, unification of exchange rates and adopting more flexible exchange rates and making the current account

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convertible. However, the extent of interest rate spread has not changed much in Bangladesh despite these measures.[1] The average interest rate spread was estimated to be 6.13 percent in the 1980s, 6.37 percent in the 1990s and 5.35 percent in the 2000s.[2] From the concern that a large interest rate spread is an impediment to growth prospects, Bangladesh Bank (the central bank of Bangladesh) had been persuading banks to reduce the spread in a rational manner. As moral suasion did not work, Bangladesh Bank imposed ceilings on both lending and deposit interest rates in 2008; however, the ceilings were removed in 2011 mainly due to pressure from the IMF. This back-and-forth strategy towards interest rates raises several questions: why are spreads and margins persistently high in the banking sector of Bangladesh despite financial liberalization? Why do different types of banks charge different interest spreads?

A wide range of studies identified that large spreads occur in developing countries mainly due to high operating costs, financial taxation or repression, lack of a competitive financial/banking sector and macroeconomic instability (Barajas, Steiner, & Salazar, 1999; Beck & Hesse, 2009; Brock & Rojas-Suarez, 2000; Chirwa & Mlachila, 2004). However, our understanding of the determinants of spreads and margins in Bangladesh is still limited. There is no comprehensive, rigorously conducted analysis of spreads and margins currently available for Bangladesh in part because of data limitations.[3] Two recent studies, Mujeri and Islam (2008) and Mujeri and Younus (2009) shed some light on the characteristics of interest spreads in Bangladesh. This paper makes an attempt to improve our understanding of the spreads and margins in Bangladesh by analyzing a unique panel data set relating to 43 banks for the period 1990–2008.[4] A generalized method of moments (GMM) dynamic panel regression model, namely the Arellano and Bover (1995)/Blundell and Bond (1998) model, has been applied to the data to identify the determinants of spreads and margins as well as to capture their persistency. Data have been collected from the commercial banks' balance sheets and income statements.

This study, for the first time, captures the persistency of spreads and margins in the banking sector of Bangladesh by applying dynamic GMM estimators. The estimated persistency effect (0.42) indicates that a major part of interest spreads in Bangladesh can be explained by some unobserved characteristics of the banking sector including inefficiencies of management arising from revealed preferences, weaknesses in risk management practices and technological skills. In general, both less-competitive market structure and management inefficiency are held responsible for persistently high spreads in Bangladesh.

As a result of financial liberalization, market power has shifted from the state-owned commercial banks (SCBs) to the old but big private commercial banks (PCBs) in the post-liberalization period (after 1999). This indicates that financial reform measures undertaken in the 1990s have not contributed much to make the sector more competitive.

The rest of the paper is organized as follows. Section 2 provides a brief survey of literature on interest rate spreads. Section 3 provides an overview of the financial sector reforms and development in Bangladesh. Section 4 discusses data and variables and Section 5 discusses methodology and results. Finally, Section 6 concludes the paper.

2. A brief survey of literature

What are the determinants of spreads and margins? Does financial liberalization decrease the level of spread? These two questions are addressed in most studies dealing with interest spreads. A review of the determinants of spreads is provided in Table A.1 in Appendix.

Beck and Hesse (2009) categorize the determinants of spreads and margins under four broad-based views. First, the *risk-based view* captures some systematic differences across borrowing sectors and deficiencies in the contractual and informational frameworks driving high spreads and margins. According to this view, bank size, capital ratio, bank liquidity, operating costs, non-performing loan (NPL) and non-interest income are associated with risk management practices of banks. Second, the *small financial system view* focuses on the fixed transaction cost component of financial service provision and the difficulties in exploiting the resulting scale economies. The market share of deposits and/or loans usually represents the size of the financial system.

Third, the *market structure view* usually focuses on the competitiveness and the extent of privatization and foreign bank entry into the banking system. Market concentration ratios are used to assess the relevance of this view towards spreads and margins. Finally, the *macroeconomic factors* such as exchange rates, interest rates, inflation rates and GDP growth rates are also considered as driving forces of interest spreads and margins in the banking system. All these factors together or partially can contribute to high spreads and margins in a less developed financial system. Are the determinants similar across countries? Interest spreads are higher in developing countries than developed countries. Among developing countries, spreads are higher in African and Latin American countries than those in Asian countries. It can be observed from Table A.1 in

[1] Banks were allowed to adjust their own rates since February 19, 1997. Further flexibility in the interest rate was introduced on July 12, 1999 permitting banks to differentiate interest rates to individual borrowers except exporters (Economic Trends, Bangladesh Bank).

[2] Interest rate spreads in Bangladesh are comparable to other South Asian countries. The average spreads for the last five years was 6.0 percent in Pakistan, 4.95 percent in India and 6.18 percent in Sri Lanka (source: respective central bank). Thus the Bangladesh case is nothing but a typical South Asian case of maintaining moderate but persistent level of spreads.

[3] In recent days, a growing tendency can be seen among banks to be engaged in capital market businesses through operating merchant banks, creating mutual funds and trading individually in the stock markets. However, their profits from share-market business are not clearly reported in any of the published documents.

[4] A total of 48 banks are now operating in Bangladesh, of which long time-series data are available for 43 banks.