Banking Customer Perception about Interest Rate Spread (IRS) In Pakistan.

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Abstract

This study is about banking consumer perception and awareness regarding banking interest rate spread (IRS) in Pakistan. Many banking consumer perceive that in Pakistan, banks are charged more interest rate on loans, but pay a small amount in term of profits on their saving, although there are many factors behind the borrowing and offering rates difference for banking consumers, which are beyond the scope of this study, and it is limited to the consumers perception only. This study objective is to conduct the study about banking interest rate paid on savings (profit) and charge on Loans (Mark Up) and limited only to existing depositors and borrower of the banking industry of Pakistan.

This research is exploratory in nature to find out the answers of questions regarding the consumer awareness and unit of analysis for my research are current customers of commercial banks and questioner used as research Instruments to gather data. Results of research shows that many consumers of banking industry consider banks are paying less on consumer savings in term of profit, but charge higher rate of interest on loan and advances in term of markup, although banks get funds form State Bank of Pakistan and other banks at lower rate. A large number of respondents also dissatisfy with current banking interest rate spread in the Pakistan.

Keywords: Interest Rate Spread (IRS), Banking Consumer’s Perception, Credit Growth, Karachi Inter Bank Offer Rate (KIBOR)

1. Introduction

This study is to find out the consumer awareness and perception regarding lending and borrowing interest rates difference in Pakistani banking industry. It’s an effort made to found out whether practically is there consumer awareness about spread in banking system.

Monetary policy of the State bank of Pakistan plays an important role in the banking industry as well as the economic stability in the country. Higher rate of profit will attract the domestic and household to keep their savings in the banks, rather than keep money at home, or purchase different commodities e.g. gold, silver or purchase property and purchase of dollar and prize bonds. Similarly lower mark up rate attracts large scale industries, speculators and households. Except the speculators and consumer loans, which are not considered for economic growth, others are helpful for the economy. Loans for business purpose plays a vital role in the economy, even a short amount of loan to entrepreneurs can reduce the unemployment in the country.

According to Syed Waqar Hussain & Asmat Ullah (2012) after the privatization process of nationalized banks in year 2000, banking sector rapidly increased horizontally and vertically.

Interest spread of the Pakistan’s banking industry has been on the rise for the last few years. The increase in interest spread discourages savings. Financial intermediation is essential for economic development in the country. High interest rate spread (IRS) in developing countries to several factors, such as high operating costs, financial repression, lack of competition and market power of a few large dominant banks enabling them to manipulate industry variables including lending and deposit rates, high inflation rates, high risk premiums in formal credit markets due to widely prevailing perception relating to high risk for most borrowers.

According to Ndung’u, N. & Ngugi, R.W. (2000) if the banking sector's interest rate spread is large it discourages potential savers due to low returns on deposits and thus limits financing for potential borrowers.

2. Literature Review

Now a days the interest and determination of rate of interest have assumed extra ordinary importance, interest consider as an opportunity cost of keeping the money in cash.

According to Shahid (2012) Present Value concept plays an important in interest rate determinates and discount rate is an important tool of monetary policy in Pakistan.

Keynes Liquidity trap concept, the rate of interest can fall up to a specific minimum level, and in our economy we are seems decreasing interest rate couldn’t increase growth in the economy due to various reasons and investors prefers to hold money rather than invest.

Saunders and Schumache (2002) in their international study of six selected European countries and the US during the period 1988–1995 for a sample of 614 banks found that regulatory framework, market structure, and a risk premium are the main sources of increasing net profit margins.

Afanasieff, et al. (2002) studies the Determinants of Bank Interest Spread in Brazil using a panel data of 142 Brazilian banks for the February 1997-November 2000 period concluded that stable macroeconomic environment and regulations can reduce the interest margins.

In a extensive study, Muhammad Ayub Siddiqui (2011) study the determinants of bank interest spread using a sample of 14 commercial banks in Pakistan for the period of 2000 to 2008 that the most efficient banking structure persists and sustains with minimum possible interest margins in competitive environment of free market economies. His study also found imperfect completion in banking industry of Pakistan.
Idrees Khawaja and Musleh-ud Din (2007) study has investigated the determinants of interest spread of the banking industry in Pakistan, results show that inelasticity of deposit supply leaves little incentive to the bankers to adopt competitive practices and therefore the concentration ratio, which captures the level of competition, fails to exercise an influence upon spread.

According to SBP (2011) banking system of Pakistan is characterized by high banking spreads, which are generally linked to the efficiency of financial intermediation and competition in the banking sector.

Claeys and Vennet (2004) investigates the determinants of bank interest margins in Central and Eastern European countries assess Capital adequacy is an important determinant of bank margins The pricing of lending risk plays an important role in explaining high interest margins.

According to SBP (2011) the introduction of a minimum rate of return on savings deposits has contributed to a visible increase in returns on deposits, which has ultimately helped in narrowing banking spreads.

Zhou and Wong (2008) study results indicate that the determinants of net interest margins in the Chinese market include market competition structure, average operating costs, degree of risk aversion, transaction size, implicit interest payments, opportunity cost of reserve, and management efficiency.

Tatum Blaise Pua Tan (2012) investigates the Determinants of Credit Growth and Interest Margins in the Philippines and Asia .Bank-level analysis suggests that interest margins in the Philippines rise with bank size, bank capitalization, foreign ownership, overhead costs and tax rates. Using bank-level data for a number of Asian economies, we find that higher growth, lower inflation, higher reserve requirements, greater banking sector development, smaller stock market development and lower government deficits reduce net interest margins.

Kunt and Harry (1998) as financial intermediaries, banks play a crucial role in the operation of most economies. Indicators of better contract enforcement, efficiency of the legal system and lack of corruption are associated with lower realized interest margins and lower profitability. Also found some evidence that government regulations have an impact on bank margins.

M.H.Khan and B. Khan (2010) study analyses the determinants of interest rate spreads of commercial banks operating in Pakistan by using a balanced panel of 28 banks from 1997 to 2009. Deposits constitute the main funding source for banks in Pakistan. They consider the share of non-remunerative deposits in total deposits and find that an increase in this share is positively related with banking spreads. Also find that administrative expense is particularly important in explaining commercial bank spreads in Pakistan.

MUGERI K. & YOUNUS (2009) explain the interest rate spread (IRS) in the banking sector of Bangladesh using panel data of 48 banks covering the period of 2004 to 2008. The analysis shows that the higher the non-interest income as a ratio of total assets of a bank, the lower its spread. Further inefficiencies and inadequate competition among the banks is a significant source of high IRS in the country's banking sector.

According to Abiodun O.F & David T (2008) interest rate spreads has important implication for the growth and development of economy.

**Modelling Framework**

In this study

Customer Perception is Dependent Variable

Interest Rate Spread (IRS) is Independent Variable

**Problem Statement**

Banking consumers in Pakistan perceived that bank are charged very high interest rates on loans provides to consumers and pay very low profit rates on consumer’s saving.

**Research objectives**

- To determine the Banking consumer’s perception about lending rates offered by the banks in Pakistan.
- To find the Banking consumer’s perception about profit rates offered by the banks in Pakistan on their savings.
- To study the Banking consumer’s awareness regarding the State Bank of the Pakistan (SBP) discount rate, monetary policy and interest rate spread in Pakistan.
Hypothesis
Ho= Banking interest rate spread is not very high in Pakistan.
Ha = Banking interest rate spread is very high in Pakistan.

3. Research Methodology & Procedure

Research Design: The research design for this topic can be break down into following issues

Purpose of the study: This research is exploratory in nature to find out the answers of questions regarding the consumer awareness.

Study Setting: It is a field study and all the data collection is done in natural environment no artificial settings are made to find out answers.

Unit of Analysis: Unit of analysis for my research is current customers of commercial banks.

Respondents of the study: Existing consumers of Banks

Research Instruments: Questioners used to gather data

Sampling Method: Non Probability Convince based Sampling Method in which 100 Questionnaires were distributed to consumers of a commercial bank in Karachi Pakistan.

4. Results & Analysis

Out of 100 respondents, 93 filled questionnaires received. There were a total of 17 questions asked from the respondents using different question formats. Response Rate of the sample is 93%

Following are the results of different questions asked to the respondents

Figure 1: The best option for saving money by households.

Figure 1 is showing that a large number of respondents preferred to invest their savings in gold and other commodities due to increasing prices day by day, Banks Profit and loss accounts (PLS) and other deposit schemes also consider better due to fixed and secure incomes. Increasing Dollar value also attract some domestic investor to invest in foreign currencies.

Figure 2: Familiar with the term Karachi Inter Bank Offer Rate (KIBOR)

Figure 2 is showing mostly respondent of this study are familiar with this term.
Figure 3: Maximum profit paid by banks in Pakistan.

Figure 3 is showing that a large number of respondents believe that banks are not paying enough profit and return on their savings and paying profit between 6-10% on their savings annually.

Figure 4: Satisfy with profit Paid by Banks on their saving.

Figure 4 is showing that Mostly respondent dissatisfied with the current percentage of profit offer or paid by the banks on consumers’ deposits.

Figure 5: Profit paid by banks on savings is reasonable.

Figure 5 is showing that a large number of individuals of this study consider current rate of profit paid by banks on savings not reasonable and a less amount is paid by the banks on their savings.
Figure 6: What do you think Interest/Mark Up Charged by Banks on Loans is reasonable.

Figure 6 is showing that mostly respondent consider that banks are charged higher rate of interest on loans from the borrowers.

Figure 7: Minimum interest/Mark up Charge on borrowing/loan in Pakistan?

Figure 7 is showing that many respondents perceive that banks are charged more than 15% interest on loans offered to consumers.

Figure 8: Interest rate spread (IRS) is reasonable in Pakistan.

Figure 8 is showing that a large number of respondent consider interest rate spread (IRS) is higher in Pakistan, only a few number of respondent believes that IRS is reasonable due different factor like operating cost, cost of funds and provision for bad debts.
Figure 9 is showing that mostly respondents believe that current discount rate is below 10%, due to recent news in print and electronic media regarding monetary policies announced by the State Bank of Pakistan (SBP) so the people aware that banks get funds from other banks and State Bank of Pakistan (SBP) and lower cost.

5. Conclusion

On the basis of above research I can conclude that banking consumer is dissatisfy with profit paid by banks on their savings and preferred Private Institutions over government institutions to deposit their savings due to several reasons mainly the service standards and quality. May depositors still like to invest in gold, due to its increasing price all over the world, some household preferred “committee” and prize bonds for saving purpose due to complex banking procedures and requirement e.g valid CNICs, prove of income/wealth, source of funds, NTN, Anti Money Laundering procedures etc.

The findings of the research also indicated that many customers believe that banks get money/funds from the State bank below the 10% and charge from the loan consumers (borrower) more than 25% on different loan products e.g running finance/OD, home/car loans etc. Banking consumers also dissatisfy with profit paid by the banks on their saving accounts which in normally between the 6-10% annually.

Some people think that interest is a reward against the fall in purchasing power of the money. Interest rate spread affect domestic savings and investment in Pakistan.

The discount rate is the interest rate that the State Bank of Pakistan charges commercial banks when they borrow money from its discount window to meet short-term liquidity needs. This interest rate is not directly linked to the interest rates that banks charge their borrowers, but it is very closely correlated with the KIBOR which is used in most lending contracts as the benchmark interest rate, mostly respondent perceive that banks are charging higher percentage on loans and paying very less profit on savings. In Pakistan interest rate spread is higher than as compare to other countries in the world.

Reference list


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