Chapter I
Introduction

Background of the Study

Financial institution plays an important role to flourish an economy. The growth of any economy is highly determined by the development of banking industry. Banks have significant influence in shaping the trend of an economy. Banking industry has been recognized as the most critical agencies in a financial system. Banking industry provides market transparency; perform risk transfer and risk management functions and deals with complex financial instruments and markets which he)p to flourish economy of any country. Among these financial institutions the role of commercial bank is of high importance. These commercial bank acts as an intermediate between surplus units and deficit units of funds following the directives of central bank under the given legal system. Banks make a profit by intermediating between depositors and borrowers (Acaravci & Calmi, 2013). It is of high importance that commercial bank thrives in any situations of an economy. In order to protect commercial bank, it became mandatory for central bank to supervise commercial bank through directives and qualitative measure.

As financial intermediary, banks play a crucial role in operation of economy. It mobilizes the funds from one sector of economy to another thus facilitating the balanced economic development. The effectiveness of the banking system is channeling funds from surplus to deficit sectors is often determined by examining the spread between lending and deposit rates and by assessing the degree of operational efficiency of the banking industry (Taci and Zampieri, 1998). A high spread acts as an impediment to the expansion of financial intermediation necessary for growth and development of an economy. It is often argued that the higher the spread, the higher would be the cost of credit to the borrowers for any given deposit rate. Alternatively, a high spread could mean unusually low deposit rates discouraging savings and limiting resources available to finance bank credit (Mujeri and Younus, 2009).

Researchers show that the efficiency of financial intermediation can affect economic growth. Crucially, it affects the net return to savings and the gross return to investment. The spread between these two returns mirrors bank interest margins, in addition to transaction costs and taxes borne directly by savers and investors. Thus bank interest spreads could be interpreted as an indicator of the efficiency of the banking system. It