Research in International Business and Finance 32 (2014) 139–158

Contents lists available at ScienceDirect

Research in International Business and Finance

journal homepage: www.elsevier.com/locate/ribaf

Why have bank interest margins been so high in Indonesia since the 1997/1998 financial crisis?

Irwan Trinugroho [a,c,*], Agusman Agusman [b], Amine Tarazi [a]

[a] *Université de Limoges, LAPE, 5 rue Félix Eboué, 87031 Limoges Cedex, France*
[b] *Bank Indonesia (the Central Bank of Indonesia), Jl. M. H. Thamrin, No. 2, Jakarta 10350, Indonesia*
[c] *Faculty of Economics and Business, Universitas Sebelas Maret, Jl. Ir. Sutami 36A, 57126 Surakarta, Indonesia*

ARTICLE INFO

Article history:
Received 18 September 2013
Received in revised form 16 April 2014
Accepted 25 April 2014
Available online 9 May 2014

Keywords:
Bank interest margins
Financial intermediation
Small scale loans
Indonesia

ABSTRACT

We investigate the determinants of net interest margins of Indonesian banks after the 1997/1998 financial crisis. Using data for 93 Indonesian banks over the 2001–2009 period, we estimate an econometric model using a pooled regression as well as static and dynamic panel regressions. Our results confirm that the structure of loan portfolios matters in the determination of interest margins. Operating costs, market power, risk aversion and liquidity risk have positive impacts on interest margins, while credit risk and cost to income ratio are negatively associated with margins. Our results also corroborate the loss leader hypothesis on cross-subsidization between traditional interest activities and non-interest activities. State-owned banks set higher interest margins than other banks, while margins are lower for large banks and for foreign banks.

© 2014 Elsevier B.V. All rights reserved.

1. Introduction

It is widely known that the average net interest margin, the difference between interest income and expenses divided by interest-earning assets, of Indonesian banks is relatively higher than those observed in other countries particularly in the East Asia region (Rosengard and Prasetyantoko, 2011).

* Corresponding author. Tel.: +33 555149251; fax: +33 555149251.
E-mail addresses: irwan.trinugroho@etu.unilim.fr, irwan.trinugroho@gmail.com (I. Trinugroho), agusman@bi.go.id (A. Agusman), amine.tarazi@unilim.fr (A. Tarazi).

http://dx.doi.org/10.1016/j.ribaf.2014.04.001
0275-5319/© 2014 Elsevier B.V. All rights reserved.

A number of cross country studies point out this fact. Demirgüç-Kunt and Huizinga (1998) show that the average margins of Indonesian banks for the 1988–1995 period was 3.6%, higher than those of neighboring countries such as Singapore (2.2%), and Malaysia (2.7%). Using data after the 1997/1998 financial crisis from 1999 to 2008, López-Espinosa et al. (2011) show that, in Indonesia, average bank interest margins (4.85%) were much higher than, for example, the average interest margins of Japanese banks (1.92%). Recently, Lin et al. (2012) have indicated that with a value of 6.36% the average bank margin of Indonesian banks over the 1997–2005 period, was the highest compared to other Asian countries in their sample.[1] Their work also shows that the interest margin of Indonesian banks is significantly higher after the 1997/1998 crisis than before.[2]

The present paper extends the literature on the determinants of net interest margins by studying Indonesian banks which have experienced a problem of persistently high net interest margins since the 1997/1998 financial crisis. We hypothesize that the persistence of high interest margins in Indonesia is affected by a set of simultaneous factors which are the structure of loan portfolios, the degree of competition, the level of income diversification, cost efficiency, bank size as well as credit risk and liquidity risk. We also assume that net interest margins are influenced by bank ownership characteristics. To our knowledge, this paper is the first that comprehensively studies the determinants of net interest margins in Indonesia after the crisis. We incorporate two unique loan portfolio components, small scale loans and property loans, as factors explaining interest margins which contextually matter in Indonesia. Studying interest margins with regard to the ownership and governance characteristics of banks is also important. Using pooled regression techniques as well as static and dynamic panel regressions, we find evidence that the structure of loan portfolios do matter in the determination of interest margins. Specifically, small scale loans contribute to increase bank margins, whereas housing (property) loans tend to reduce interest margins. Also, operating costs, market power, risk aversion and liquidity risk significantly and positively affect margins, while credit risk and cost to income ratio are negatively associated with margins. Our results also corroborate the loss leader hypothesis on cross-subsidization of lending and non-interest activities. Furthermore, state-owned banks have higher margins than other banks, while foreign banks and large banks set lower margins.

The remainder of this paper is organized as follows. Section 2 reviews previous work on related issues. In Section 3, we provide some background on Indonesian banking. In Section 4, we describe our data, variables, and empirical model. Section 5 reports the results and robustness checks. Section 6 concludes our findings and provides policy implications.

2. Literature review

As financial intermediary institutions, banks collect deposits from surplus spending units with an interest cost and distribute it to deficit spending units by charging an interest rate. Although high interest margins are associated with inefficiency (Drakos, 2003; Beck and Hesse, 2009; López-Espinosa et al., 2011), some studies, however, use interest margins as a measure of bank profitability (e.g. Chen and Liao, 2011). The issue of how banks set their interest margin has been extensively studied in the literature. In a seminal paper, Ho and Saunders (1981) introduce the dealership model in which banks perform as a risk-averse intermediary between the demanders and suppliers of funds. Their model posits that positive interest margins will prevail as long as banks are risk-averse agents and face uncertainty even in a highly competitive market. They conclude that a bank's interest margin is determined by four factors: the degree of managerial risk aversion, the size of transactions, market structure, and the variance of the market interest rate. Many empirical studies have expanded and examined the dealership model using cross-country data or by focusing on a single country in the context of developed and developing countries (*e.g.* Angbazo, 1997; Saunders and Schumacher, 2000; Maudos and de Guevara, 2004; Carbó Valverde and Rodriguez Fernandez, 2007; Hawtrey and Liang,

[1] We conduct our own computations using data from BankScope for banks in 9 East Asia countries from 2005 to 2009. The average margin of Indonesian banks is 5.7% far above the 3.03% on average for the eight other countries.

[2] López-Espinosa et al. (2011) also show that average interest margins of Indonesian banks have increased over their sample period.

Download English Version:

https://daneshyari.com/en/article/1002905

Download Persian Version:

https://daneshyari.com/article/1002905

Daneshyari.com