Market Interest Rate and Commercial Banks Profitability: An Empirical Study

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Abstract

Significant integration and liberalization of financial markets worldwide have led to increased volatility in the world economy. As a result, a number of economists and policy makers are interested in the impact of market rate fluctuations on bank profitability. If this is known, then evaluating the trade-off between interest rate stability and other policies becomes more likely. With this kind of evaluation, policy makers will be able to place appropriate weights on interest rate policies, in relation to others. Consequently, this paper investigates the effect of market interest rate[1] risk on bank profitability using a modification of Flannery's (1981 & 1983) model with similar assumptions for the period 2000-2008 in Jamaica for the National Commercial Bank (NCB) and Bank of Nova Scotia (BNS) Jamaica Ltd. The results indicate that market interest rates, in particular, Treasury bill rates have a small effect on bank profitability, across the two major banks in Jamaica. Also, interest rate risk (volatility) has a very small, but negative impact on bank profitability.

JEL Classifications: C3, GO, G21.
Key Words**:** Bank Profitability, Interest Rates, Volatility, Interest Rate Risk.

1. Introduction

Significant integration and liberalization of financial markets worldwide have led to increased volatility in the world economy. As a result, a number of economists and policy makers are interested in the impact of market rate fluctuations on bank profitability. If this is known, then evaluating the trade-off between interest rate stability and other policies becomes more likely. With this kind of evaluation, policy makers will be able to place appropriate weights on interest rate policies, in relation to others. Consequently, this paper investigates the effect of market interest rate[2] risk on bank profitability using a modification of Flannery's (1981 & 1983) model with similar assumptions for the period 2000-2008 in Jamaica for the National Commercial Bank (NCB) and Bank of Nova Scotia (BNS) Jamaica Ltd.

Interest rate risk, which is caused by unexpected and unfavourable changes in interest rates, is a major contributor to the increased volatility that accompanies globalization. To measure how these rate changes affect a bank's profitability, English (2002), posits that the overall impact of interest rate fluctuations on the bank's economic value may be assessed; or an assessment of the implications of interest rate risks on future cash flows may be done. This study tests the impact of market interest rate risk on commercial banks' profitability in Jamaica, using the former approach. This is done through the use of a Seemingly Unrelated Regression technique.

2. Literature Review

Interest rate risk[3] is the exposure of a bank's financial condition to adverse movements in interest rates. Studies have shown that banks' net interest margin (NIM) is the most sensitive to fluctuations in interest rate. Samuelson (1945) argues that under general market conditions, bank profits increase with rising interest rates. He states: "The banking

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[1] Market interest rate refers to the interest rate set by demand and supply in the money market.

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[3] The Basel Committee on Banking Supervision research (2004).