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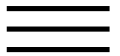

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Abstract

This paper explores the determinants of optimal bank interest margins based on a simple firm-theoretical model under multiple sources of uncertainty and risk aversion. The model demonstrates how cost, regulation, credit risk and interest rate risk conditions jointly determine the optimal bank interest margin decision. We find that the bank interest margin is positively related to the bank's market power, to the operating costs, to the degree of credit risk, and to the degree of interest rate risk. An increase in the bank's equity capital has a negative effect on the spread when the bank faces little interest rate risk. The effect of rising interbank market rate on the spread is ambiguous and depends on the net position of the bank in the interbank market. Our findings provide alternative explanations for the empirical evidence concerning bank spread behavior.

JEL classification

G21

Keywords

Bank interest margins; Credit risk; Interest rate risk; Risk aversion

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