CHANGING INCOME STRUCTURE AND PERFORMANCE: AN EMPIRICAL ANALYSIS OF INDONESIA BANKING SECTOR 1999-2007

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ABSTRACT

This paper investigates the relationship between the changing patterns of bank's source of income and risk adjusted performance. A database of 81 banks over the period of 1999 to 2007 is constructed for the 5 public sector banks and 76 private banks to compare their change in income composition. Bank's performance is measured by risk adjusted return on BIS risk allocated capital (RARORAC). We argue that in a competitive financial market in order to change the profitability drivers in banking, Indian banks need to improve their non-interest income and also augment risk adjusted interest income through better risk based pricing.

Key Word : Service, Area, and Inters

INTRODUCTION

Banks are one of financial intermediaries that play a key role in financing economic development and more superior compare to other financial institution as banks can solve with asymmetric information and high cost operation in financial intermediary activities (Stiglitz & Greenwald, 2003). The economic literature has identified two channels through which banks exert their influence on the process of economic growth. First channel considers effect of finance to growth through capital accumulation (Hicks, 1969), where banking institutions by reducing transaction costs and by diversifying risks, enable the mobilization of savings to finance the investments necessary to stimulate and sustain economic development. Second channel, emphasizes the allocation of loans, where development is driven by innovations and the role of banks is to identify the most innovative entrepreneurs and by providing them with the purchasing power necessary to divert the means of production, contribute to economic growth.

The important role of banks in emerging countries such as Indonesia is even true since the development of non-bank financial institutions has been impeded by inadequate institutional infrastructures and weak investor basis. Therefore, the rise and fall of banks in Indonesia would have strong correlation with the economic development in Indonesia. The slow growth and the lack of bank loans identified as one of the important factors causing the process of Indonesia's economic recovery to proceed slower compared to other Asian countries affected by the