Innovations

Factors affecting the profitability of commercial banks in Nigeria

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Abstract
The banking sector is a crucial component of any economy since it is crucial in transferring savings from surplus to deficit units to fuel the country's economic activity and growth. A nation's banking industry may considerably contribute to its economic development and growth if it is strong, healthy, and competitive. In light of this, this article investigates the factors that affect the Nigerian banking industry's profitability. Secondary data from books, journal papers, and other publications was used to substantiate the findings presented in this theoretical study. To reduce the possibility of error and improve the study's validity and reliability, multiple secondary sources were utilized. This paper comes to the conclusion that a company's earnings must remain comparatively steady in order for it to expand and grow through time, regardless of whether it is publicly traded or privately owned. Its external environment must also be properly understood and accurately predicted, in addition to its degree of earnings. This paper recommends measures that will encourage commercial banks to lower credit risk and reduce their liquidity holdings. Based on conclusion, the paper recommends among others that the government of Nigeria should take the appropriate steps to increase investors' trust in the stock market.

Keywords: 1.*Banks, 2.Profitability, 3.Internal factors, 4.External factors, 5.Stakeholders*

Introduction

Banks make a substantial contribution to the expansion and improvement of the economy. Banks contribute in the nation's financial development and offer a range of alternatives for customers to set up investment and savings programs using tried-and-true investing strategies. The measurement of the banking sector's performance and identifying the factors that influence it are becoming more and more important as the body of literature on the sector's significance expands. The banking industry's profitability supports not only economic expansion but also aids in absorbing adverse financial shocks from the outside world. Profitability is the ability of the company to generate income; it is often determined by the after-tax net income and the return on equity. The real interest rate, inflation rate, real gross domestic product, imports, and exports of a nation are only a few of the macroeconomic factors that have an impact on profitability. Therefore, it would appear essential to look at the factors that affect profitability. Profitability is the main issue, and there are many internal and external elements that might affect a bank's profitability. The main internal factors are liquidity, capitalization, bank size, and operational effectiveness. On the other hand, external factors include GDP and inflation. Indicators of bank profitability include Return on Equity (ROE), Return on Assets (ROA), and Net Interest Margin (NIM) (Kiran & Muhammmad, 2019). Some banks are seen as being more profitable, while others are seen as being less profitable. What affects banks' profitability is the key concern. Information on the factors that affect bank profitability would aid management and regulators in developing plans for the banking industry's steady and sustainable growth.

To enable the necessary flow of savings into profitable investments, which depends on the development of suitable financial institutions, notably banks that are capable of producing an acceptable amount and quality of investment, is a crucial prerequisite for boosting economic growth. In order to attain their main goal of profitability, formal financial institutions, notably banks, are founded to provide financial services to the economy. These organizations offer a variety of financial services to their clients, including deposit collection and credit disbursement. According to Obidike, Ejeh, and Ugwuegbe (2015), financial institutions are set up to offer financial services with the intention of turning a profit. The nation's central bank oversees the banking sector. The central bank keeps an eye on all of the commercial banks' operations. In this regard, the Central Bank of Nigeria (CBN) oversees controls, promotes, directs, and supervises the operations of Nigeria's commercial banks.

Bank-specific features and country-specific characteristics, often known as internal factors and external factors, respectively, are among the variables influencing the profitability of banks. The capital ratio, bank size, managerial effectiveness, credit risk, diversification, and liquidity ratio are among the features unique to banks. The per capita GDP, broad money growth rate, inflation rate, and corruption perception index are all country-specific variables. Examining how macro-level issues impact the banking industry and the profitability of banks is crucial for policymakers. In contrast to wealthy countries, banks in developing nations are run differently. In comparison to wealthy countries, the percentage of government securities in banks' investment portfolios is higher in emerging nations. While consumer lending is on the rise in industrialized countries, lending to businesses is more prevalent in developing nations. Furthermore, one important tool of monetary policy in developing nations is the reserve requirement. In comparison to 60% of rich countries, 95% of developing countries now have reserve requirements. It has been noted that improvements in the banking industry have not come uniformly across all nations. In particular, the banking and financial system has advanced more in industrialized nations than in emerging nations, where the advancement has been little (Alarussi & Alhaderi, 2018). Therefore, it is necessary to investigate what factors affect the profitability of Nigerian banks.

Review of Related Literature

A bank's profitability could be impacted by a variety of factors. While some of these factors have a negative impact, others can help banks be more profitable. The administration of the bank may have some control over various elements that affect productivity, while the administration may not have any control over others. The administration of the bank has the most control over internal factors. These are sometimes known as "bank specific factors," and depending on how they specifically affect the bank's profitability, they can be viewed as either positive or bad. Credit risk, capital structure, loan portfolio management, liquidity management, expense management, and diversification of the bank's goods and services are examples of these variables. The external variables that are beyond the management's control may include elements related to the level of competition in the industry where the bank operates (concentration), barriers related to entry and exit from the industry, the rate of economic growth, the type of rules and regulations that apply to banks, inflation, money-related extending, fiscal policies, and monetary policies (Jo-Ann, Gobind & Bushra, 2020).

According to Juliana, Djoko, and Rudi (2018), there are three efficiency concepts that can be used to evaluate a financial institution's performance: 1. Cost efficiency, which measures a bank's cost in relation to banks with the lowest operating costs (producing the same output using the same technology). 2. Profit standard efficiency compares a bank's ability to make the most profit at a given output price level to the best bank profit in the sample to determine the efficiency level of the bank. In this model, input and output prices are set by the market in a scenario of perfect competition (Maghyereh & Awartani, 2014). Thus, the bank functions as a price-taking agent because none of the banks can control the price of inputs or outputs; and 3. Alternative profit efficiency is frequently connected to a scenario of imperfect market competition, where the bank is presumptively in a position to control the price of output but not the price of input. By choosing the output price, p, and the number of inputs, x, for a given number of outputs, y, and input prices, r, the bank will achieve the highest possible profit margin. The indirect profit function, which is the answer to the optimization problem with the following equation, is also known as the indirect profit alternative function:

$$\begin{array}{ll} & Max\pi p, x = P'Q = (p,r)(y,-x)' \\ s.t\ g(p,y,r,z) = 0 & h(y,x) = 0 \end{array}$$

Matthew and Thompson (2005) recommend adopting The Intermediation Approach to determine input and output for assessing bank efficiency using parametric or non-parametric techniques. According to this method, financial institutions act as intermediaries, go through transformations, and move financial assets from surplus to deficit units. Labor costs, capital expenditures, and interest on deposits are all examples of institutional inputs. Financial investment and loan credit are two ways to quantify output. Although the notion of profitability differs across studies, the factors that influence profitability have been thoroughly empirically investigated. When profitability metrics are ignored, the majority of banking research has found that the capital ratio, loan-loss provisions, and spending control are significant factors in high profitability. The drivers or variables of profitability that will be taken into account in this study fall into two categories: endogenous (internal) and exogenous (external) factors of profitability. Internal drivers of bank performance or profitability are things that a bank's management decisions have an impact on. The operating outcomes of banks will undoubtedly be impacted by such managerial consequences. Although good management results in strong bank performance, it is challenging, if not impossible, to directly evaluate management quality. In fact, it is implied that such a quality will show in the operating results. As a result, it's typical to evaluate a bank's success in terms of the financial factors present in financial statements like the income statement and balance sheet.

Factors outside of the management of a bank are known as external determinants of bank profitability. They represent things that don't have anything to do with the bank. However, management might attempt to position the institution to benefit from predicted developments by anticipating changes in the external environment. The macroeconomic and financial structure aspects make up the two main parts of the external determinants. In conclusion, it seems that prior empirical research has hinted at a potential relationship between bank profitability and various internal and external determinants like bank assets, loan-loss provisions, total deposits, and inflation. However, this relationship is far from being conclusive as different authors have used the inclusion and exclusion of various variables in their studies. The political climate of Nigeria, where the banking sector is located, is comparatively unstable and impacted by pervasive corruption, a lack of transparency, and poor infrastructure standards. The implication was that a significant portion of country risk in the Nigerian banking system is political risk. For instance, banking upheaval that resulted in the CBN seizing control of 18 banks between 1994 and 1996 and revoking the licenses of five banks occurred after a tumultuous political climate brought on by the suspension of the 1993 Presidential Election. Adefemi, Babatunde, and Akande (2021) ascribe the financial crisis in African nations including Nigeria, Kenya, Uganda, and Zambia to moral hazard brought on by political meddling in this environment. Political instability shortens the tenures of governments and policymakers, which leads to inadequate and unstable economic policies that negatively impact the stability of the financial system and the economy. Therefore, stable political regimes, the responsibility of political office holders, and a country's democratic characteristics determine financial development.

Determinants of Profitability of a Bank

Capital Adequacy Ratio

A certain level of capital is required for each bank. To perform the following basic tasks, capital must be adequate: first, as a reserve for financial and operational risks; second, as necessary funds to organize and run the financial company before other sources of funding are collected; third, as a means of assuring the public that the bank has enough capital as a financial institution; fourth, as a source to develop new services and supporting facilities; and fifth, as a growth engine that aids in economic expansion (Hosen, 2020).

Credit Risk
Banks' capacity to fulfill their obligations or influence on liquidity risk is decreased by credit risk. The risk of loss resulting from the bank not receiving income from the credit discharged to the community backing the bank to pay interest and other expenses is the second effect. Non-performing loans, which reduce a bank's cash flow, are the hallmark of credit-risky banks (Abbas & Espinoza, 2016).

Bank Size
Banks measure the amount of assets they have accumulated to determine whether they are huge or little. Because they are powerless to alter the state of the economy, large banks are more competitive than small banks. Due to their industry diversification, large banks typically have access to capital at lower costs (Hosen, 2020). Therefore, the efficiency of the bank increases with growth.

Market Power
In a market with imperfect competition, businesses can raise prices without reducing the supply of the desired goods. The main causes of inefficiency are incomplete competition and market power. According to Hosen (2020), improved production efficiency will result in lower output costs per unit, allowing the product to be supplied in the market at prices that are competitive. Interest rates are prices in the banking sector that are viewed as the cost of raising capital and a source of bank income through operations related to credit distribution.

Bank Liquidity Ratio
A bank is deemed liquid if it possesses sufficient cash or other liquid assets, as well as the capacity to expand the amount of quick funds from other sources and meet other financial commitments and payment obligations as needed. There must be enough liquidity to cover the urgent monetary requirements (Abbas & Espinoza, 2016).

Empirical Review
According to Juliana et al. (2018), the profitability of commercial banks in Indonesia between 2010 and 2016 was considerably impacted by factors such as bank size, capital adequacy (CAR), liquidity (LDR), credit risk (NPL), and market power. According to Oladele, Sulaimon, and Akeke (2012), operating costs, the relationship between cost and income, and equity to total assets all had a big impact on how well Nigerian banks performed. By controlling operating costs, charging commissions and fees, and capital levels, Chavarin (2014) examined the factors that determine the profitability of 45 commercial banks in Mexico. He also discovered that barriers to entry into the market and barriers to competition have a disproportionately high persistence of profitability. In their 2011 study, Khan, Anuar, Choo, and Khan examined the factors that affect bank profitability in Pakistan and discovered that factors such as bank size, loan growth, deposits to asset ratio, and deposit to loan ratio had significant positive relationships with profitability, whereas net interest margin, tax, and overhead expenses had significant negative relationships. Ongore and Kusa (2013) discovered that, with the exception of liquidity variable, bank-specific factors (capital adequacy, management effectiveness, and liquidity management) strongly affect the performance of commercial banks in Kenya.

Samad (2015), for example, identified a few bank-specific factors like the loan-deposit ratio, loan-loss provision to total assets, equity capital to total assets, and operating expenses to total assets and the researcher finds that they significantly affect the performance of commercial banks. Other studies on banks in particular have also been conducted in Bangladesh. A number of bank-specific characteristics were taken into account by Mahmud, Mallik, Imtiaz, and Tabassum (2016) while calculating the profitability of commercial banks in Bangladesh. According to the study, the size of the bank, the capital adequacy ratio, and the ratio of total debt to total equity all significantly affect a bank's performance. According to Hossain and Hossain (2015), profitability is highly correlated with capital ratio, total loan as a percentage of total assets, and staff expenditure as a percentage of total assets, but highly negatively correlated with cost income ratio and total expenditure as a percentage of total assets.

According to the study, there is no correlation between profitability and bank size, operating efficiency, savings deposits as a percentage of total assets, branches, liquidity ratio, and asset management. The primary factor affecting a bank's profitability is its size, which is typically expressed as total assets. Prior research by Obamuyi (2013), Francis (2013), Hirindu and Kushani (2017), Alarussi and Alhaderi (2018), Sahyouni and Wang (2018), and others demonstrated a favorable correlation between bank size and profitability. The earlier research made the assumption that the link was monotonic, with either a positive or negative effect being seen. But according to economic theory, there may be size economies up to a level equal to the firm's size, after which there may be diseconomies.

Another crucial factor that could impact banks' profitability is the capital ratio. Some prior studies discovered that the capital ratio had a favorable effect on profitability, assuming a monotonic relationship (Abreu & Mendes, 2001; Obamuyi, 2013; Samad, 2015; Islam & Nishiyama, 2016). Additionally, there are elements that are country-specific that affect a bank's profitability. The primary factor that determines a bank's profitability is per capita GDP, which is advantageous for comparing the performance of other nations because it shows the relative country's performance. Greater productivity and economic activity are shown by higher per capita GDP levels (Petriaa, Caprarub, & Ihnatovc, 2015). The inflation rate is a significant contributor to bank profitability. Profit consequences from inflation vary depending on predicting abilities. Profit will almost certainly increase if one can correctly anticipate the rate of inflation. The wide money growth rate is used to analyze how the money supply affects revenue. Along with narrow money's elements like the currency in circulation, broad money often consists of components like demand deposits and time deposits held with banks. An indicator used to gauge a nation's level of corruption is the corruption perception index. According to Arshad & Rizvi (2013), corruption has a favorable impact on profitability. The profitability of banks is significantly impacted by these factors at the national level.

Conclusion and Recommendations

Money markets utilized for short-term cash and investments are centered on the banking industry. As a result, the sector is an important part of the financial system and is essential to the growth and development of countries. The analysis of profits is crucial not only for the insight it offers on the state of the economy in a given year, but also because profits play a significant role in determining growth and employment over the medium term. Through the impact earnings have on corporate investment and saving decisions, changes in profitability have a significant role in economic growth. This is so that businesses can better manage their cash flow and have more options for obtaining financing for corporate investment (i.e. through retained earnings). Greater investment is made possible by easier access to capital, which raises output, capacity, competitiveness, and employment. Profitability is a key factor in determining an organization's ability to exist, expand, and survive in business. It is accurate to say that as profitability rise, shareholders' value may also rise significantly. The ability of the company organization to keep its profit year after year is referred to as profitability. In conclusion therefore, the banking sector success will undoubtedly contribute to the growth of the economy of the country by creating more jobs and bringing in more tax income for the government coffers. Additionally, by paying out a greater dividend, it will increase investors' income and raise everyone's standard of life. An organization's earnings must remain largely consistent in order for it to expand and flourish through time, whether it is publicly traded or privately owned. Along with its level of revenues, the external environment must be correctly understood and effectively predicted. In order to accomplish organizational goals, the corporate organization must ensure that the appropriate technology is pursued. The study makes the following recommendations in light of the conclusion:

1. The government of Nigeria should take the appropriate steps to increase investors' trust in the stock market and other markets.
2. The decision-makers can create both short- and long-term plans for enhancing the performance of the banks.
3. The central bank should always forecast how macroeconomic factors will affect the banking industry and devise strategies for ensuring its steady and long-term growth.

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