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The Determinants of Profitability in the Nigerian Deposit Money Banks

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Abstract: The study aims to evaluate the Determinants of Profitability in the Nigerian Deposit Money Banks. The population of the study comprised of 20 Banks listed on the Nigerian stock exchange with a working population of 6 Banks using filter as a sampling technique to select the working population, and which a period of five (5) years was used from 2012-2016. The data generated from the Bank's annual report and account was analyzed by means of Descriptive statistics, Correlation and Regression analysis using Eviews 8.0. The result of the analysis was tested at 0.05 (5%) level of significance. The findings of the study show that Capital Adequacy has a significant relationship with return on equity; it also revealed that Asset Quality and Management Efficiency have no significant relationship with Return on Equity of Deposit Money Banks. Therefore, the study recommended that, the management of the Deposit Money Banks should endeavour to intensify effort to increase their Capital Adequacy by issuing more shares to the public for subscription more especially at premium to generate additional capital in form of share premium, and should decrease their asset especially non-current assets through leasing in order to increase their profitability, it is also recommended that the management of the deposit money banks should seek for other means that will increase their profitability other than management efficiency such as liquidity by increasing their current assets more than their current liabilities, and also should not consider the age of the bank as one of the factors that will increase their profitability and consider other factors that has significant on the banks profitability such as capital adequacy and liquidity as found in this study.

Keywords: Profitability, Banks, Asset Quality, Capital Adequacy, Management Efficiency

I. INTRODUCTION

In any country, the banking sector occupies an important place in the financial system. The reasons for this are the roles banks play in the development of an economy. Banks act as intermediary between the deficit and surplus units in an economy, that is, they mobilize funds and allocate them among competing ends. They facilitate the use of appropriate monetary policy instruments a well as make the transmission mechanism reliable and policies effective. The banking sector is an instrumental in the pursuit of stabilization policies and in structural transformation
.
Banks serve vital intermediary role in a market — oriented economy and have been seen as the key to investment and growth. [1] Observed that commercial banks play a crucial role in the nation's economy, by using various financial instruments to obtain surplus funds from those that forgo current consumption for the future. They also make same funds available to the deficit spending unit (borrowers) for investment purposes. In this way, they make available the much needed investible funds required for investment as well as for the development of the nation's economy.

It is important to note that the business of banking is services — oriented, that is, banks render services to their customers. The significant changes that have occurred in the financial sector of developing economies like Nigeria have increased the importance of operating efficiency and bank performance analysis of Nigerian deposit money banks (DMBs). As observed by [2] performance analysis is an important tool used by various agents operating either internally to the bank or who form part of the banks, externals operating environment. The banking system plays the all-important role of financial intermediation of ensuring that adequate funds are mobilized and supplied to the real sectors of the economy for productive purposes.

One key indicator of bank performance is the net margin on loans and advances. Since interest on loans and advances constitute the major turnover of banks, the net margin on loans and advances has direct impact on bank profit performance. Other performance indicators are return on equity (ROE), which is a relevant measure of equity investor's residual claims of corporate income. It is the relevant profit indicator which assesses overall profit performance. Others include the return on asset (ROA),

return on investment (ROT), and the CAMEL rating system which is adopted by bank for international settlement, is an acronym for capital adequacy, asset quality, management efficiency, earning strength (profitability) and liquidity. The major aim of this study is therefore to identify the potential determinants of profitability in the Nigerian listed Deposit money Banks.

Statement of Research Problem

The techniques of delivering banking services and range of products and services in the market have also changed. The antecedent of banks proliferation and lack of control by the supervisory authority led to the paper profit declared by banks in order to stay afloat. The effect of this unethical practice led to the distress in the banking industry with the introduction of the prudential guidelines and statement of accounting standard (10) which majorly dwelt on the provisioning for loans and advances. The lesson learnt from the distress in the banking industry was that profitability alone does not determine the yardstick for financial performance of banks. Financial analysis is therefore, the process of identifying the financial strengths and weaknesses of a firm by properly established relationship between the items of the balance sheet, the profit and loss accounts [3]. [4] Reports that, a good means of measuring the performance of a bank and other business organizations is the financial ratio, which shows the relationship between data in the financial statement. These financial statements are prepared as general information models of an enterprise at regular period, normally each year [5].

[2] Report that, the financial ratio analysis in investigates the different areas of bank performance, such as profitability, asset quality and solvency. The tools that can be used to calculate performance are obtained from the information derived from periodic financial reports or statements produced by the accounting systems of such banks and also observed that the parameter of measuring performance varies from country to country, depending on the sector involved. [5] Also reports that the quality of banks assets includes both the performing and non-performing loans which are a vital tool for monitoring authority in assessing the performance of banks in Nigeria. The deficiency of profitability and other method used by other researchers as a measure of financial performance led to the use of CAMEL which is an acronym for capital adequacy, Asset quality, Management, earnings and Liquidity as well as size out of which three were selected by the researcher as the major determinants of profitability in the Nigeria Deposit Money Banks.

Objectives of the Study

The aim of this study is to identify the potential Determinants of Profitability in the Nigerian Deposit Money banks. Other specific objectives are to:

1. Examine the relationship between capital adequacy and return on equity of DMBs in Nigeria.
2. Evaluate the impact of asset quality on return on equity of Nigerian DMBs.
3. Analyses the relationship between the management efficiency and return on equity of Nigerian DMBs.

Hypothesis of the Study

On the basis of the above objectives, the following hypotheses below are formulated in null form in order to guide the study.

H1: There is no relationship between capital adequacy and return on equity of DMBs in Nigeria.

H2: There is no relationship between asset quality and return on equity in the DMDs.

H3: there is no relationship between management efficiency and return on equity of DMBs in Nigeria.

II. LITERATURE REVIEW

Capital Adequacy

Capital adequacy has been the focus of many studies and regulator as it is considered to be one of the main drivers of any financial institution's profitability [6] and [7]. In contrast, other studies argue that in a world of perfect financial markets, capital structure and hence capital regulation is irrelevant [8].

However, [9] posited that the regulator ensures that banks have enough of their own capital at stake. [10] Supported this proposition arguing that these regulations help in reducing negative externalities (e.g., disruptions to the payments system and a general loss of confidence in the banking system) in addition to boosting the slow economic growth hence the Gross Domestic Product (GDP).

According to [11], capital adequacy measures provide significant information regarding a firm's returns, while a few of the individual variables representing asset quality and earnings are informative. Size and growth and loan exposure measures do not appear to have any significant explanatory power when examining returns. The study establishes that the change in total assets is also significant. Thus the present study has included these variables in its model to examine the relationship between capital adequacy, cost income ratio and profitability.

[12] Asserted that the proposition that there should be a negative relationship between a bank's ratio of capital to assets and its return on equity may seem to be self-evident as to not need empirical verification. It is therefore important to note that [13] found evidence for a positive relationship that is, the ratios of capital to assets and returns on equity were positively related. He argued that a higher capital ratio (with reduced risk of bankruptcy) should reduce a bank's cost of funds, both by reducing the price of funds and the quantity

of funds required, thus improving a bank's net interest income and hence profitability.

However, [9] found the contrary - that is, negative relationship between capital and profitability exists. [14] Explained that banks are required to hold capital equal to a certain percentage of the total risk- weighted assets. Under the risk-based standards, capital consists of two parts: tier-I capital (comprising equity capital and published reserves from post-tax retained earnings) and tier-II capital (comprising perpetual preferred stock, loan loss reserves, sub-ordinated debt, etc.). Using the expected bankruptcy theory, [15] explained that the expected bankruptcy costs hypothesis can be used to explain part of the observed positive relationship between capital asset ratios (CARs) and return on assets (ROA) under certain circumstances.

Asset Quality

[16] Emphasized that when loans are not repaid as it often happens, banks get into problems, as such debts are sometimes written off as bad. The balance sheet of any lending bank is believed to confirm this. [16], explained further that ability to repay the point of any lending decision, one may then ask why bad debt does occur? Some reason given by [16] include non- existence of a loan policy set out by the banks, non-compliance with such a loan policy analysis of financial data, bad judgment, inadequate project monitoring, incomplete knowledge of customers' activities etc.

However, asset quality and bank efficiency are non-related, because operating personnel normally are not involved in the selection and supervision of borrowers, and loan and credit personnel do not engage in the management of operations. However, banks at the edge of bankruptcy appear to have a high non-performing loan ratio as well as a low cost efficiency. Some authors discovered that the level of liquidated banks and high efficient banks (the most efficient banks) is huge [17].

Other researchers found that banks having non-bankruptcy problems exhibit a negative relationship between efficiency and non-performing loans [18]. [17] opined that a bank's ranking is significantly affected by asset quality which is always an essential factor in rating and management evaluation. [19] Also observed that one of the key features that the best community banks hold is good quality assets. Given that bad quality assets can prompt a bank rating downgrade and that it becomes more difficult to earned depositors' trust, such banks can therefore only attract deposits by having a higher deposit rate. Together, a conclusion can be drawn: asset quality will not only influence the operating costs of banks, but will also affect the interest costs of the banks as well as their operating performance.

[20] Reported that asset quality management is considered one of banks major management problems in 2001 based on the self administered questionnaires served to the members of American Bankers Association Board which composed of one-third of bank officials from all U.S. banks, the result of the above survey sufficiently proves that asset quality management is a common issue for bankers in practice. Similarly, Gene Miller (CEO of America Corp.) considered asset quality as the second most important management issue and formed a task force to specifically handle rising bad assets.

According to [21], non-performing loans (NPL) has an inverse relationship with banks' profitability. Hence, they suggested that it is of crucial importance that banks practice prudent credit risk management and safeguarding the assets of the banks and protect the investors'interests. Similarly, [22] contended that for banks to continue operations; they must make enough money through lending and fiduciary activities or services to cover their operational and financing costs, plough back retained earnings to finance future operations. This will enhance not only the survival but also their growth and profitability.

From the management accounting perspective, bank asset quality and operating performance are positive related because if a bank's asset quality is insufficient such will have to increase its bad debt losses as well as expend more resources on the collection of non-performing loans [23]. When banks list the loan amount for collection, banks will incur extra operating costs from non-value-added activities so as to handle and supervise the collection process such as a regular tracking the debtor's financial status, being vigilant of the collateral value, rearranging the amortization plan, paying expenses for contract negotiation, calculating the costs to withhold etc. The costs include winning the trust from management and the public, preserving the safety and completeness of the banks, preventing the banks from being rated poor as a consequence of external affairs, reducing deposits because of a loss in clients' faith, extra costs to monitor loan quality, and higher future costs generated by the ignorance of the problems from other operations that is generated when the loan quality issues grips the attention of the senior management [24].

Operating Efficiency

The importance of operating efficiency for banks was put into evidence by a study done on Indian scheduled commercial banks [25]. Its findings were that key determinants of operational efficiency were affected by the global financial crisis. This reinforces the need to understand the drivers of operational efficiency for proper management of commercial banks.

According to [26], any empirical approach that is used to model the relationships between capital and risk also needs

to take account of bank efficiency. [27], states that government should regulate investment policy for banks for them to be more efficient and be globally competitive.

[28] Employed panel data through stochastic frontier analysis model to measure the source of operating efficiency of Indian banking sector. The major determinant of technical efficiency as revealed by the study are fixed asset, deposit and deposit to total liabilities while, the cash deposit ratio is not insignificant. In a study on the determinants of operating efficiency in Egypt banking sector, [29] found asset quality, capital adequacy, credit risk and liquidity as the main determinants of efficiency in the highly competitive banks.

According to Ines [30], in the study determinants of Tunisian bank efficiency, using Data Envelopment Analysis, it was discovered that market share in Tunisian banks has inverse impact on their efficiency. Quality of asset suggests that most banks engage in risky activities including credit. In the study, high ratio of quality of asset has negative effect on efficiency because it shows a small yield of bank assets. Tunisian banks tend to be less efficient because they suffer from under evaluation of Credit Risk and misallocation of resources. Therefore, it was denoted that the cost of the Tunisian banks increases with non performing loans. Employing Data Envelopment fixed effect regression analysis by [31], efficient banks in Latin American capitalize earnings in liquidity because the ratio of loan loss reserve to gross loan is negatively related to efficiency and banks with low quality loan are expected to have low efficiency.

Also, [32] in their Data Envelopment Analysis of efficiency in Malaysian Islamic banks found that size of banking operation, asset quality improves operational efficiency as opposed to corporate social responsibility which is negatively related to cost/operational efficiency. Malaysian banks will be more efficient if they can control non-performing loans, in that the high cost of maintaining loan default will be avoided.

Furthermore, employing Data Envelopment Analysis by [33], it was noted that variable of interest rate is inversely related to technical efficiency and the rate of Inflation on the contrary has positive relationship with banks operational efficiency.

III. METHODOLOGY

For the purpose of this research work, Time Series Research Design was employed because the study obtains information through secondary data sourced from the annual reports and accounts of the selected sample banks. The data used in this study are quantitative secondary data collected from the financial statements of the sampled deposit money banks in Nigeria for a period of five years from 2012 to 2016. Regression analysis technique was used to measure the relationship between a dependent variable and independent variables.

Model 1

Relationship between Capital adequacy and Return on equity

ROE= a+b1CA+b2LQDT+b3SZ+e……

ROE= Return on equity

a= slope

b= intercept

CA= Capital Adequacy

LQDT= Liquidity

SZ= Size

e= Error term

Model 2

Relationship between Asset Quality and Return on equity

ROE= a+b1AQ+b2LQDT+b3SZ+e……

ROE= Return on equity

a= slope

b= intercept

AQ= Asset Quality

LQDT= Liquidity

SZ= Size

e= Error term

Model 3

Relationship between Management Efficiency and Return on equity

ROE= a+b1ME+b2LQDT+b3SZ+e……

ROE= Return on equity

a= slope

b= intercept

ME= Management Efficiency

LQDT= Liquidity

SZ= Size

e= Error term

IV. RESULTS AND DISCUSSION

Regression Results

Table 1 Capital Adequacy and ROE

Variable	Coefficient	Std. Error	t-Statistic	Prob.
CA	1.449623	0.463265	3.129147	0.0043
LQDT	522.4111	88.90035	5.876368	0.0000
AGE	-0.248524	0.224864	-1.105218	0.2792

C	9.067716	5.970082	1.518859	0.1409

R-squared	0.689171	Mean dependent var	10.11267
Adjusted R-squared	0.653306	S.D. dependent var	5.975012
S.E. of regression	3.518133	Akaike info criterion	5.477304
Sum squared resid	321.8087	Schwarz criterion	5.664130
Log likelihood	-78.15955	Hannan-Quinn criter.	5.537071
F-statistic	19.21572	Durbin-Watson stat	1.227715
Prob(F-statistic)	0.000001		

Source: *Generated by the researcher from annual reports 2012-2016 using Eview version 8.0*

Table 1 Shows that CA has a positive relationship of 1.45 with ROE and the p-value of CA shows the perfect relationship of 0.0043 and the relationship is significance because the p-value is less than 0.05(5%) level of significance.

Therefore, Liquidity shows significant relationship with ROE at 1% level of significance. However, Age is insignificant related to ROE at 28% while is above 10% level of confidence.

Hypothesis I

H_{01}: There is no relationship between Capital Adequacy and return on equity of deposit money banks.

Based on the above analysis, there is insignificance positive relationship between Capital adequacy and Return on Equity of deposit money banks because the R-square and adjusted R-square are graeter than 50% level of significance as shown in the above analysis which is 69%(0.69) and 65%(0.65) respectively, that is to say the variable selected influence the ROE by 69% and 31% is left for other variables not captured in the model, which has positive p-value of 0.0043 which is less than 5% level of significance, so the null hypothesis is thereby rejected. It is therefore concluded that Capital Adequacy has a significant relationship with return on equity on deposit money banks.

Table 2 Asset Quality and ROE

Variable	Coefficient	Std. Error	t-Statistic	Prob.
AQ	0.874674	11.24322	0.077796	0.9386
LQDT	570.8403	104.7436	5.449884	0.0000
AGE	-0.365494	0.264529	-1.381678	0.1793
C	11.38188	8.720111	1.305245	0.2037

R-squared	0.578671	Mean dependent var	10.06138
Adjusted R-squared	0.528112	S.D. dependent var	6.074048
S.E. of regression	4.172514	Akaike info criterion	5.822357
Sum squared resid	435.2468	Schwarz criterion	6.010949
Log likelihood	-80.42417	Hannan-Quinn criter.	5.881421
F-statistic	11.44536	Durbin-Watson stat	1.143550
Prob(F-statistic)	0.000065		

Source: *Generated by the researcher from annual reports 2012-2016 using Eview version 8.0*

Table 2 shows that AQ has a positive relationship of 0.9386 with ROE and the p-value of AQ shows a relationship of 0.9386 and the relationship is insignificance because the p-value is greater than 0.05(5%) level of significance.

Therefore, Liquidity shows significant relationship with ROE at 1% level of significance. However, Age is insignificant related to ROE at 17% while is above 10% level of confidence.

Hypothesis II

H_{02}: There is no relationship between Asset Quality and return on equity of deposit money banks.

Based on the above analysis, there is insignificance positive relationship between Assets Quality and Return on Equity of deposit money banks because the R-square and adjusted R-square are greater than 50% level of significance as shown in the above analysis which is 58%(0.58) and 53%(0.53), that is to say the variable selected influence the ROE by 58% and 42% is left for other variables not captured in the model,

which has positive p-value of 0.9386 which is greater than 5% level of significance, so the null hypothesis is thereby accepted. It is therefore concluded that Asset Quality has no significant relationship with return on equity of deposit money banks.

The control variables, liquidity and age show a P-value of 0.0000 and 0.2792 respectively which is also insignificant at 0.05 (5%) level of significance.

Table 3 Management Efficiency and ROE

Variable	Coefficient	Std. Error	t-Statistic	Prob.
ME	0.468081	0.827038	0.565973	0.5763
LQDT	558.7943	102.9606	5.427262	0.0000
AGE	-0.359673	0.259969	-1.383525	0.1783
C	9.377234	8.643019	1.084949	0.2879
R-squared	0.577320	Mean dependent var		10.11267
Adjusted R-squared	0.528549	S.D. dependent var		5.975012
S.E. of regression	4.102578	Akaike info criterion		5.784674
Sum squared resid	437.6099	Schwarz criterion		5.971500
Log likelihood	-82.77011	Hannan-Quinn criter.		5.844441
F-statistic	11.83742	Durbin-Watson stat		1.155082
Prob(F-statistic)	0.000045			

Source: *Generated by the researcher from annual reports 2012-2016 using Eview version 8.0*

Table 3 shows that ME has a positive relationship of 0.4681 with ROE and the p-value of ME shows a relationship of 0.5763 and the relationship is insignificance because the p-value is greater than 0.05(5%) level of significance.

Therefore, Liquidity shows significant relationship with ROE at 1% level of significance. However, Age is insignificant related to ROE at 18% while is above 10% level of confidence.

Hypothesis III

H_{02}: There is no relationship between Management Efficiency and return on equity of deposit money banks.

Based on the above analysis, there is insignificance positive relationship between Management Efficiency and Return on Equity of deposit money banks because the R-square and adjusted R-square are greater than 50% level of significance as shown in the above analysis which is 58%(0.58) and 53%(0.53), that is to say the variable selected influence the ROE by 58% and 42% is left for other variables not captured in the model, which has positive p-value of 0.5763 which is greater than 5% level of significance, so the null hypothesis is thereby accepted. It is therefore concluded that Management Efficiency has no significant relationship with return on equity of deposit money banks.

V. CONCLUSIONS

From the systematic review of the determinants of bank profitability in the Nigerian deposit money banks. The following conclusions are drawn for the study in the light of the summary of the major findings:

I. The study confirms that Capital Adequacy has a significant relationship with return on equity on deposit money banks as one of the ratio employed to evaluate the profitability of Nigerian deposit money banks. This means an increase in the level of capital adequacy will affect the profitability of deposit money banks.

II. The study also confirms that Asset Quality has no significant relationship with return on equity of deposit money banks. This means an increase or decrease in the level of asset quality will not affect the profitability of deposit money banks.

III. The study also confirms that Management Efficiency has no significant relationship with banks profitability, measured by ROE as one of the ratio employed to evaluate the profitability of deposit money banks. This means that an attempt to increase the level of management efficiency will not bring a better profitability.

Lastly, the control variable liquidity is significant at 1% level of significance. This means increased in liquidity will lead to small increase in profitability, and the other control variable age has no significant on ROE of deposit money banks in Nigeria. This means the age of the company will not affects its profitability.

VI. RECOMMENDATIONS

The following recommendations are drawn based on the conclusions of the study.

It is confirmed that banks profitability (ROE) is positively related to the capital adequacy of deposit money banks. The management of the deposit money banks should endeavour to intensify effort to increase their capital adequacy by issuing more shares to the public for subscription more especially at premium to generate additional capital in form of share premium.

I. The study also confirms that profitability (ROE) is negatively related to asset quality of deposit money banks. The management of the deposit money banks should decrease their asset especially non-current assets through leasing in order to increase their profitability.

II. Profitability (ROE) has no significant relationship with management efficiency of deposit money banks. It is recommended that the management of the deposit money banks should seek for other means that will increase their profitability other than management efficiency such as liquidity by increasing their current assets more than their current liabilities.

III. Finally, profitability (ROE) has no significant relationship with the age of deposit money banks. It is recommended that the management of the deposit money banks should not consider the age of the bank as one of the factors that will increase their profitability since both the two (AGE and ROE) has no significant relationship, the management should consider other factors that has significant on the banks profitability such as Capital Adequacy and Liquidity as found in this study.

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