

Determinants of private bank profitability

[Finance](#), [Banks](#)



Determinants of Private Banks' Profitability in Ethiopia: Panel Data Evidence

Yigremachew Benti Addis Ababa Email: com March 2008 1

Abstract Using the standard static as well as dynamic models, the study tries to find systematic evidence on the determining factors for the corporate profitability of private commercial banks in Ethiopia. The study utilizes data on balance sheet as well as income statement account items of all the domestic private banks, which have at least been operational since 1999/00 fiscal year.

In effect six private commercial banks have been included in this survey. Regarding the estimation methodology, I employed a static panel data model. However, in order to correct for parameter endogeneity resulting from the likely presence of unobserved bank specific effect and also to address the dynamic relationship, I use the augmented generalized method of moments (GMM) estimator developed by Arellano and Bond (1991) and further developed by Blundell and Bond (1998). As to the econometric software, I make use of STATA to obtain estimates of the static as well as dynamic panel models.

All in all, the study results indicate that interest and non-interest incomes and interest expense are the main determining factor for the profitability of private banks in Ethiopia both in static and dynamic conditions. Increase exposure to credit risks has also strong negative impact on profit. The empirical result evident that there is persistence in profitability and speed of adjustment to industry average (equilibrium) is about 16%. On the contrary, market concentration has no significant role on private banks' profitability.

The contribution of other bank level variables (like fixed asset investment, capital adequacy ratio and employees' productivity) has considerable positive impact on profit. Macroeconomic conditions such as inflation and tax have significant unfavorable impact on operational performances of private banks. In contrast, improvement in foreign sector or overall economy has significant positive effect on corporate profitability.

2 1. Introduction

1. 1 Background

The financial sector, which is congeries of financial institutions, has multifaceted roles in serving the needs of the economy.

The service is rendered through providing three major functions, such as intermediation or allocation, operational and payment systems. Operational and allocative functions are the provisions of financial resources to meet borrowing needs of individuals and other economic agents. The main microeconomic function of financial intermediaries is the provision of facilities to collect and invest saving funds. Provision of a sound payment mechanism is also the other expected service from financial institutions. Hence the performance of a financial institution is perhaps measured in terms of the above major roles of the banking business.

The performance of a bank mainly relies on the provision of these functions. Thus, addressing the impacts of internal and external factors on these functions is meant for identifying the inherent effect on the overall operational performances of a particular bank or the financial sector in general. It is instrumental for management decisions through indicating the critical operational variables, existing problems or opportunities and also answering key policy questions. However, evaluating a bank performance is

a complex process that involves assessing interaction between the environment, internal and external activities.

No consensus has yet emerged on a set of indicators, which is more relevant to assessing financial soundness or building effective early warning systems. Hence, this study intends to systematically measure or closely examine the static as well as dynamic relationship between profitability and those internal and external competitive factors using eight years longitudinal data. 1. 2

Objectives of the Study The main objective of the study is to find systematic evidence on the main determinants of the corporate profitability of private commercial banks in Ethiopia.

The specific aims are to: Briefly assess the overall operational performances of private commercial banks in Ethiopia and characterize major components of operational profit 3 Empirically investigate the major factors that determine the profitability of private commercial banks in Ethiopia. To provide an input for the required sector specific stress testing and shed light on policy repercussion on private commercial banks in Ethiopia 1. 3

Data & Methodology I use secondary data obtained from the successive annual reports of the selected six private commercial banks in the Sector and from other concerned government organizations.

Specifically, those data that pertain for evaluating internal performances will be constructed from various years accounting data contained on the aforementioned banks' Balance Sheets and Financial Statements. The methodology followed in this study is both descriptive statistics and rigorous longitudinal data analysis procedures. The static as well as dynamic panel

data estimation methods that believe to be instrumental to inculcate prudential indicators of financial soundness are employed. 1. 4 Scope & Limitation of the Study

The study encompasses all observed performances of the selected private commercial banks starting from 1999/00 to 2006/07 fiscal year. However, due to the opaqueness of the Sector and the expected shortage of longitudinal data and other elusive structural difficulties, the study is compelled to limit itself mainly on officially reported accounting data, major macroeconomic and few sector specific secondary data. Due to their relative younger age, the study likely faces problem of accuracy resulted from limited observation or degrees of freedom.

In tandem, efforts made to inculcate limited parameters with strong significance in explaining the model. The rest of the paper is organized as follows. Next chapter briefly describes the major operational performances of private banks in Ethiopia during the last eight years. Literature review will be briefed in chapter 3. Chapter 4 presents the data source and overall sample construction of the study. The methodology followed and the associated empirical results and 4 their implications have been discussed in Chapter 5. The last Chapter is devoted to conclusions and recommendations. 2.

Overview of Major Operational Performances of Private Banks in Ethiopia 2. 1 Operational Performances During the reported eight fiscal years, private commercial banks in Ethiopia have registered remarkable operational performances. Total deposits have risen by an average annual growth rate of 32%. However, as Table 1 shows, total deposits have been increasing with a

nearly decreasing rate. This is attributed for the increase in stockpile and apparently signifies the extent of competition in the Sector coupled with the probable resource limitations due to the dichotomous nature of the Economy.

In addition, the annual average growth rate of demand deposit has excelled from that of saving and fixed time deposits. However, saving deposit has been remained the major source of private banks' deposits followed by demand deposits. For instance, the yearly average shares of saving and demand deposits are 63% and 26% of the total average yearly deposits of private commercial banking sector, respectively. Moreover, their respective share during the reported period has been more or less stable. Table 1: Deposit Performance of Private Commercial Banks Deposits Demand Saving Fixed