Traffic jam in dhaka city

[Literature](), [Russian Literature]()

EXAMINATION OF PROFITABILITY IN THE CONTEXT OF BANGLADESH BANKING INDUSTRY Nadim Jahangir', Shubhankar Shill2 and Md. Amlan Jahid Haque3 Abstract Loans are the riskiest asset of a bank, but these loans play a pivotal role in banks' profitability. Banks 'profitability depends on the results of some parameters and among them Bank b Return on Equity, Market Size, Market Concentration Index, and Bank RiskMeasure are widely used and the same are investigated in the Bangladesh Banking Industry in this study for a period of the last six years. The data comes from the annual reports of individual banks listed in Dhaka Stock

Exchange (DSE) and from the Bangladesh bankb published statistics book (Scheduled Banks Statistics). Correlation matrix and stepwise regression have been used for the purpose of data analysis. The analysisfinds that market concentration and bank b risk do little to explain bank b return on equity, whereas bankb market size is the only variable providing an explanation for banks return on equity in the context of Bangladesh. Introduction The tmhtional measure ofprofitabilitythrough stockholder's equity is quite different in banking industry ffom any other sector ofbusiness, where loan-to-deposit ratio works as a very good ndicator ofbanks' profitabiJity as it depicts the status of asset-liabilitymanagement ofbanks. But banks' risk is not only associated with this asset- liability management but also related to growth opportunity. Smooth growth insures higher future returns to holders and there lies the profitability which means not only current profits but future returns as well. So, market size and market concentration index along with return to equity and loan-to-deposit ratio seize the attention of analyzing the banks' profitability. The banking industry of Bangladesh is a mixed one comprising nationalized, private and foreign ommercial banks. Many efforts have been made to explain the performance of these banks. Understanding the performance ofbanks requires knowledge about the profitability and the relationshps between variables like market size, bank's risk and bank's market size with profitability. Indeed, the performance evaluation of commercial banks is especially important today because of the fierce competition. The banking (1) Dr. Nadim Jahangir (Associate Professor) holds a Ph. D. in Management from Australian Catholic University and now is teachmg in the Independent University of Bangladesh. (2) Shubhankar Shill (Lecturer) holds Master degree inFinancefrom Dhaka University (Bangladesh) and now is teaching in the School of Business, Independent University of Bangladesh. (3) Md. Arnlan Jahid Haque (Lecturer) holds a Master degree in Management from Rajshahi University (Bangladesh) and now is teaching in the School of Business, Independent University of Bangladesh. 36 ABAC Journal Vol. 27, No. 2 (May - August, 2007, pp. 36 - 46) Examination of PI . ofitability in the Context ofBangladesh Banking Indusqr industry is experiencing major transition for the last two decades. It is becoming imperative for banks to endure the pressure arising from oth internal and external factors and prove to be profitable. Until early 1985, Bangladesh had a highlyrepressed financial sector (Chowhdury, 2002). Banks and other financial institutions were fully owned by the government. In the early part of 1980, Bangladesh entered into the IMF and World Bank adjustment programs and the process of privatization and liberalization gained momentum under the influence ofthe World Bank and the IMF. Since then the banking industry of Bangladesh has become an attractive ground for both domestic and foreign investors to take part in the game. It is of utmost importance that these layers prove themselves profitable. Andrews (1975) noted that it is essential to understand the strategies to achieve greater profitability. In line with this, the current study makes an effort to unearth those pillars which are major constituents of strategies andgoals. This paper intends to analyze the importance of internal and external factors for banks return on equity. Specifically, the purpose of the study is to closely examine the relationships of bank's market concentration, market size, and bank's risk with return on equity. The intention is to decide which amongst the potential determinants appear to be mportant. Hassan, Khan, and Haque, (1 995) previously examined banks' profitability considering monetary affect and concentration in context of Bangladesh. However Fraser, Philips, and Rose (1974) stated that performance of commercial banks should not be measured by a single proxy but by a set of variables which are jointly determined by market structure, demand, and other factors. Therefore, the current study aims to propose and examine a framework incorporating bank's market concentration, bank's market size, bank's risk, and identify the relationships of these variables with bank's return on equity in context f Bangladesh. Literature Review Market Size Cravens (2000) elaborated that, market size is usually measured by currency, sales andlor unit sales for any product market and also in specified time period other size measurement include the number of buyers' average purchase quantity, frequency of purchase for any product oriented market. As a result the key measures of market size are market potential, sales forecast, and market share. In another study on banking reformation

Thorsten and Ross (2002) measured the market size ofbanks against the GDP and to measure bank size, Thorsten and Ross (2002) used bank credit to he private sector as a share of GDP. Demirguc-Kunt and Maksimovic (2002) suggested that the extent to whichvarious financial, legal, and other factors (e. g. corruption) affect bank profitability is closely linked to size. In addition, as Short (1 979) argued, size is closely related to the capital adequacy of a bank since relatively banks tend to raise less expensive capital and, hence, appear more profitable. Luthria and Dhar (2005) defined market size as the scale of economic activity over which agents can contact. They tried to measure market size or space by national borders. Large space creates the potential or reaping economies of scale and the scope for specialization as well. It requires specific investments in physical and human capital, as well as marketing channels, constrained by slow- moving economic activity. Market Concentration The concentration aspect is particularly important for the transition economies and it has been very commonly used as the measurement of Nadim Jrrhangir. Shubhankar ShiN and 1Mn. Amlan Jahid Haque profitability ofbanlung industry. Atbanasoglou, Brissims, and Delis (2005) argue that banking systems are highly concentrated, with little separation between central and commercial banking ctivities in order to facilitate the banks' role in the planning process. Ahighly concentrated banking sector results in market power for the banks. As opposed to perfect competition, banks having monopoly power would lead to an equilibrium characterized by higher loan costs and a smaller quantity of loanable hnds (Cetorelli & Gambera, 2001). According to Alzaidanin (2003) when a large share of the business of a given industry is controlled by few large firms or concentrated in a few pockets the situation is usually termed as a slate ofconcentration. However, Deidda and Fattouh (2002) showed theoretically as well as mpirically that the relationship between banking concentration and return on equity depended on the level of economic development. More specifically, banking concentration had an adverse impact on return on equity only in low income countries. For high income countries, there was no significant effect between the two variables. Additionally, Beck, Maksimovic, and Vojislav (2003) found that this effect is especially strong if a state has a weak legal system, high level ofcorruption and a low level ofeconomic and financial development. Since these factors are true for at least some of the economies under consideration, ne would expect low banking concentration to foster return on equity. Bank Risk According to Allen (1 997), banks tend to focus on areas where they believe they have a comparative advantage to maximize efficiency in making loans. This approach makes banks give attention to geographic, industry specific demographics, and other market characteristics to operate. Calomiris and Karceski (1 998) noted that diversification and different levels ofriskyness is the result ofdifferences across banks in the scale oftheir operations. As economic conditions vary across different regions and industrial sectors, therefore ank riskyness and return on equity also vary across different regions. Gerlach, Peng, and Shu (2004) took a different approach in defining Banks' risk. Poor management qualities in inefficient institutions have a tendency to cany higher risk (credit risk, operating risk, & liquidity). The credit risk on any individual loan can be broken down into two components, the probability that the borrower will default, and the losses incurred in the event ofdefault. In an earlier study on asset quality of commercial banks Stafon (2000) found that bank return on equity driven mainly by changes in Net Interest Margins NIMs) and loan provision which in turn were determined by asset quality. However, Greusning and Bratanovic (2003) revealed that return on equity is a revealing indicator of a bank's competitive position in banking markets and of the quality of its management. The authors further elaborated that the income statement ofa bank is a key source of information on a bank's return on equity, reveals the sources ofa bank's earning and their quantity and quality as well as the quality of the bank's loan portfolio and the focus of its expenditures. Relationship between market concentration and banks 'return on ecjuitv The mpirical findings on the relationship between market concentration and return on equity are as diverse as the theoretical underpinnings. Parsley and Wei (1 985) found that young firrns in concentrated markets receive more credits than in competitive markets, with no difference for older firms, which results in a positive effect on return on equity. In contrast, Examination of Profitability in the Context of Bangladesh Banking Indust, Cetorelli and Gambera (2001) concluded that banking concentration leads to an overall depressing effect on return on equity. The authors suggest that increased competition (thus less oncentration) causes a rise in entrepreneurship and thus a higher rate of new firm creation. Very convincing is the recent work of Deidda and Fattouh (2002) showing theoretically as well as empirically that the relationship between banking concentration and return on equity depends on the level of economic development. More specifically, banking concentration has an adverse impact on ROE only in low income countries. For hlgh income countries, there is no significant effect between the two variables. Therefore, the following hypothesis can be proposed: Hypotheis1 : There is a significant relationship between Bank's arket concentration and Bank's return on equity of commercial banks in Bangladesh. Relationship between market size and banks' return on equity Shepherd (1972) mentioned a positive relation between the market size and return on equity. Such a nature ofrelationship continues to receive a great deal of attention. Seedier and Gee (1 96 1) suggested that the variability ofthe growth rate ofbank assets declines with the market size. Demerguq- Kunt and Huizinga (2001) noted that growth ofmarket size, in contrast, is positively and significantly related to profit growth. Again by following the same path of Smirlock (1 985),

Alzaidanin (2003) mentioned a positive and significant relationship between banks' size and banks' return on equity based on product differentiations. Therefore, the following hypothesis can be proposed: Hypothesis 2: There is a significant relationship between Bank's market size and Bank's retum on equity of commercial banks in Bangladesh. Relationship between banks' risk and banks' return on equity Gizycki (2001) stated that even though return on equity is influenced by bank's credit risk, the relationship between the two is not straightforward. Movements in the retum on assets will reflect not just credit risk, ut the full range of risks, including bank's exposures to movements in interest rates and exchange rates, liquidity risk and operational risks. Moreover, banks return on equity reflects not just risk-taking, but also other factors such as the mix ofon and offbalance sheet business, operating efficiency, the level of competition within the banking market, and regulatory constraints. Banks earn higher returns by taking on riskier business, this will boost the return on equity. However, if a bank experiences losses beyond what it had provisioned for, such losses will reduce return on equity. Bourke (1 989) reports hat the effect of credit risk on retum on equity appears clearlynegative. This result may be explained by taking into account the fact that the more financial institutions are exposed to high- risk loans, the higher is the accumulation ofunpaid loans, implying that these loan losses have produced lower returns to many commercial banks. Therefore, the following hypothesis can be proposed: Hypothesis 3: There is a significant relationship between Bank's risk and Bank's return on equity of commercial banks in Bangladesh. Conceptual framework It is proposed that bank's market concentration, bank's market size, and ank's risk are important in the context oftheir relationships with bank's return on equity. Based on the preceding literature review, the following framework was proposed. Nadim Jahangir, Shubhankar Shill and Md. Amlan Jahid Haque The conceptual Mework (figure 1) depicts sample size is trimmed down to 15 because of the measured variables and their relationships in inaccessibility of data. To run the analysis data the present study. fiom the year 2000 to 2005 data were used. Measures Methodology Research setting To calculate profitability of selected banks, the following ratios were used: Only the listed banks n the Dhaka Stock . Bank's return on equity (ROE) = Exchange were selected for this study. The Net Income / Total Equity researchers collected secondary data from the annual reports of these banks. Market size= Individual bank's deposit / Total banks' deposit Srrr~lpliilg nlethod Market Concentration index = Market size Currently the Dhaka Stock Exchange has 23 listed banks. Therefore, the researchers have . Bank Risk Measure =

selected 23 banks in Bangladesh. However, the Bank's total loan / total deposit Bd's Market Concentration Bank's Market Size. B'd's Risk Bank's Return on Equity Figre1 : Conceptr~l

Framework of proposed variables and their relationshps. Examination of Profitability in the Context of Bangladesh Banking Industry The relevant reasons and credentials behind the above measures ofprofitability ofbanks are as follows: According to Al-Shamrnari M. and Salirni A. (1 998) profitability ratio especially ROE signals the earning capability of the organization. They also suggest that higher return on equity (ROE) ratio is appreciable as it is the primary indicator ofbank's profitability and functional efficiency. Besides that the authors pointed out that higher liquidityratio pulls strength of peration up. Thus, fiom their view it can be stated that bank risk can be offset through lower loan-to-deposit ratio. For bank, the capital sufficiency is important to fiu-ther growth as well as profitability. Conversely, more loans derive higher credit risk, higher rate of nonperforming loans, and lower return on asset as well as equity. They provided a data envelopment analysis (DEA) model to explore the financial position ofcommercial banks in Jordan. Therefore, ROE is used here to measure the profitabilitywhich is the most sought after measure among all. Philippatos andYildlrim (2007) recommended that the arket attractiveness and profitability has a positive relationship in the context of monopolistic banking business. Force of lending can pull up through increase efficiency of own capital and competency. However, earlier in 1977, Heggestad explained that if the individual bank has higher market share it is sure to enjoy monopoly which helps the bank to extend market concentration and reduce risk. The ultimate result is the increase ofreturn on equity (ROE). He also said that risk is a fimdamental factor in pulling up profit. But, market size diverts risk hm business and confirms smooth growth and secured ROE.