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A CRITICAL REVIEW OF LITERATURE ON FUNDAMENTAL RISK FACTORS AND PROFITABILITY OF COMMERCIAL BANKS IN NIGERIA

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Abstract: **Commercial banks all over the world play a significant role in the allocation of economic resource of countries. However, banks like other financial business entities are entitled to profits for the services which they provide. However, the pursuit for profitability comes with its own risks. The continuous decline in profitability of commercial banks in Nigeria is raising high concerns in all quarters. The current study sought to critically review literature on fundamental risk factors and profitability of commercial banks in Nigeria and provide suggestions for further research. Findings of the study provided evidence of research gaps which stem from conceptual, contextual, methodological and knowledge gaps. Most studies were centered on other countries other than Nigeria. Also, most of the studies only considered one measure of profitability. In addition, bank size and its moderating effect on the relationship between fundamental risk factors and profitability were not considered in previous studies. Furthermore, previous studies did not consider structural breaks such as the Central Bank of Nigeria regulation of minimum capital base requirement and the global financial crises. The study recommends that further research be undertaken to establish the effect of fundamental risk factors on profitability of commercial banks in Nigeria where measures of profitability such as return on equity, return on asset and net interest margin will be adopted. Also, bank size and its moderating effect on the relationship between fundamental risk factors and profitability should be considered. Furthermore, further research should consider the effect of the 2007/2008 global financial crises and Central Bank of Nigeria minimum capital requirement on profitability of commercial banks in Nigeria.**

Keywords: **Fundamental Risk Factors, Inflation, Interest Rate, Exchange Rate, Profitability and Commercial Banks.**

1. INTRODUCTION

Commercial banks all over the world play a significant role in the allocation of economic resources of countries (Ongore & Kusa, 2013). They enhance economic growth of countries by availing funds to investors for productive use as well as financial deepening in countries (Otuori, 2013). Channeling of funds from surplus spending unit (depositors) to deficit spending unit (borrowers) is one of the core functions they offer to improve efficiency. Therefore, their role in financial intermediation cannot be over emphasized.

Commercial banks have been highly profitable in Sub-Saharan Africa (SSA) as their average returns on assets over the last decade has been significantly higher than that of other banks' returns in other parts of the world (Flamini, McDonald & Schumacher, 2009). However, the case seems different in some developing countries, particularly Nigeria. Therefore,

in order to ensure the survival of commercial banks in the long run, it is important to establish the determinants of profitability so that management can employ measures that will increase and stabilize their profitability (Podder, 2012). The profitability of commercial banks is affected by fundamental risk factors (Louzis *et al*., 2011). These factors are country wide or sector wide which are beyond the control of bank management (Ongore & Kusa, 2013).

Fundamental Risk Factors

Fundamental risk factors are market parameters which determine the price and value of assets in the financial sector. The risk factors are the market parameters which, through their fluctuation, produce a change in the price and value of assets (Misund, 2017). Therefore, fluctuations of these fundamental risks induce fluctuations in the prices and value of assets which they underlie. Fundamental risk factors include inflation, exchange rates and interest rates among others. Inflation captures the idea of price level in the economy. It erodes savings and also the purchasing power of consumers because each unit of currency held by them is limited to exchange of fewer goods and services (Mang'eli, 2012). Similarly, the pricing behavior of firms is affected by inflation as the expectation of a rise or high inflation in the future leads to a corresponding increase in prices set by firms, without expecting a decline in the demand of goods and services (Gul, Irshad & Zaman, 2011).

Exchange rate refers to the amount of local or home currency required to purchase one unit of a foreign currency. A rise in the exchange rate of a local currency against a foreign currency indicates depreciation of that local currency and vice versa (Aremu, Ekpo & Mustapha, 2013). Interest rate is a fundamental risk factor that impacts on profitability. It refers to the amount a borrower pays on borrowed assets to a lender or a financial institution (Bernstein, 2014). Corb (2012) argued that interest rate is a fundamental tool used by the monetary authority to control inflation and boost economic growth and development.

Profitability

Due to the dynamic nature of the banking industry, profitability which is one of the most important criteria to measure performance of banks has come under intense scrutiny (Al-Qudah & Jaradat, 2013). Profitability is critical to the survival of commercial banks. This is because dividends issued to shareholders are sourced from profits (cash profits). Similarly, profit serves as an important source of retained earnings. Retained earnings are residual profits after dividends are paid. These earnings are important component of banks' capital and their sustainability (Akani *et al*., 2016).

In measuring the profitability of commercial banks, profitability ratios are used. These ratios include Return on Assets (ROA), Return on Equity (ROE) and Net Interest Margin (NIM). Return on asset is a comprehensive financial ratio used to measure the profitability of banks. This ratio captures the overall performance of banks. Therefore, ROA indicates the efficiency of management in transforming banks' assets into revenue (Aigheyisi & Edore, 2014).

Return on equity is defined as net income returned as a percentage of equity held by shareholders. This ratio measures bank accounting profits per dollar of book equity capital (Desaro, 2012). It indicates the effectiveness of bank management in using shareholders funds to generate profits. Net interest margin (NIM) refers to the difference between the interest income generated by commercial banks and the total amount of interest paid out to their lenders, relative to the amount of their assets (interest earning). It is the ratio of net interest income to invested assets.

Objectives of the Study

The study sought to critically review literature on fundamental risk factors and Profitability of Commercial Banks in Nigeria.

2. THEORETICAL REVIEW

Agency Theory

Agency Theory was introduced by Jensen and Meckling (1976). Over the years, the theory has been significant in explaining the profitability of financial institutions. Agency theory captures the relationship that exists between the managers of institutions and the owners of these institutions who are the shareholders (Fama & Jensen, 1983). The theory asserts that such a relationship is often characterized by agency conflicts. The managers who are regarded as the agents are contracted by the principals (shareholders) usually for a stipulated period of time to work towards enhancing the wealth of shareholders (Ross, 1973). Such a relationship mandates the managers to always protect the interests of the owners and enhance the profitability of the institution.

In respect to this study, agency theory views the profitability of commercial banks in terms of Return on Equity which is highly dependent on how managers carry out their assigned responsibilities of maximizing shareholders' wealth. Therefore, return of equity serves as an indicator of shareholders' wealth maximization by managers. The theory asserts that the managers who serve as agents may consider the achievement of their personal interest at the expense of bank shareholders (owners) (Berle & Means, 1932). The theory suggests that when this happens, it is at the detriment of banks' profitability. Therefore, owners (shareholders) can employ strategies which will yield high profitability. These strategies include rewarding management financially among others as it will in turn serve as a motivation for managers to work in the best interest of owners of the institution. Similarly, shareholders can issue threat of hostile takeover which will force the management to perform their assigned duties appropriately. Furthermore, owners can offer management part ownership of the banks which can be in the form of shareholdings as this will help in giving them some sense of belonging.

Deflation Theory

Deflation Theory was introduced by Fisher (1933). The theory is of the view that a fall in inflation results to a decline in the general price levels of assets, which in turn brings about a fall in value of businesses, decreased profitability and thus, triggering bankruptcies and collapses of institutions (Revell, 1979). The cycles results in complicated disturbances in interest rates and a fall in the value of money. These complicated disturbances are referred to as external and internal forces of businesses which impact on the level of over indebtedness that exists among creditors and debtors which easily compounds to loan default (Bernanke, 1983; Galbraith, 1954). Notably, in periods of high inflation, creditors loose while debtors gain.

In respect to this study, deflation theory asserts that high inflation brings about increased revenues and thus, high profitability. Conversely, a fall in inflation leads to a decline in revenues of commercial banks and thus, their profitability which can lead to bankruptcy or collapse of the banks. However, the impact of inflation on banks' profitability is dependent on how well it is anticipated. When inflation is well anticipated by bank managers, the impact is positive on profitability, as they will adjust interest rates accordingly to curb against such changes and vice versa.

Empirical Review

The empirical review of both local and international studies provides evidence of several research gaps. A number of studies have been carried out on fundamental risk factors and profitability of commercial banks, however, most of these studies were conducted for other countries other than Nigeria. Furthermore, previous studies are characterized by mixed results. Most importantly, the studies conducted for Nigeria for example on the relationship between inflation and financial performance, Baba and Nasieku (2016) and Aburime (2009) indicated that inflation rate has a positive and significant relationship with profitability. While Ajayi and Atanda (2012), Akani *et al*. (2016) indicated that inflation rate has a positive and insignificant relationship with banks profitability. On the other hand, Aremu *et al*. (2013) and Osamwonyi and Chijuka (2014) found out that inflation has a negative and insignificant relationship with profitability.

In respect to interest rate, Akani *et al*. (2016) and Aburime (2009) found a positive and significant relationship between interest rate and banks profitability while Baba and Nasieku (2016) indicated a negative and insignificant relationship between interest rate and profitability. Also, Osamwonyi and Chijuka (2014) provided a negative and significant effect of interest rate on profitability.

3. SUMMARY AND CONCLUSION

Previous studies on Nigeria mostly considered only one measure of profitability that is, return on equity (ROE). Also, these studies did not consider the effect of global financial crises and Central Bank of Nigeria regulation on minimum capital base requirement on profitability of commercial banks in Nigeria. Furthermore, most of the studies in respect to fundamental risk factors and profitability of commercial banks did not consider bank size and its moderating effect on the relationship between fundamental risk factors and profitability. Bank size is an important bank specific factor that accounts for economies and diseconomies of scale.

Suggestions for Further Research

In order to address the research gaps, further research should be carried out on fundamental risk factors and profitability of commercial banks in Nigeria which will adopt ROE, ROA and NIM as measures of profitability. Furthermore, further

research should establish the effect of global financial crises of 2007/2008 and the CBN capitalization regulation of 2006 on profitability of commercial banks in Nigeria.

In addition, further research on fundamental risk factors and profitability of commercial banks in Nigeria should consider bank size and its moderating effect on the relationship between fundamental risk factors and profitability of commercial banks in Nigeria. Notably, the researcher seeks to incorporate and address the above mentioned suggestions and research gaps respectively.

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