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Original Article

Determinants of Profitability of Private Banks in Ethiopia

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Abstract *- The main objective of this study was to investigate factors determining the profitability of private banks operating in Ethiopia. In order to achieve this objective and to test the research hypothesis, a causal research design was used. Only secondary data were used for this study purpose. Secondary data was collected from the financial statement of the private banks particularly from the income statement and balance sheet for the period of (2008-2017). A quantitative research approach was used. The findings of this study indicated solvency ratio, size of the bank, the growth rate of GDP of this study are positively correlated with the profitability of private banks in Ethiopia but inflation rate and interest rate are negatively correlated with the profitability of private banks in Ethiopia. Based on the findings of this study, the gross domestic product has the highest impact on the profitability of the private banks in Ethiopia. Out of the independent variables, solvency ratio and company size have the lowest impact on the profitability of the private banks in Ethiopia. The finding of this study shows that company size and interest rate have no significant effect on the profitability of the private banks of Ethiopia.*

Keywords *- Profitability, Company size, Solvency Margin, Leverage ratio, Gross Domestic Product, Inflation Rate, and private banks*

I. INTRODUCTION

Financial institutions like banks, insurance companies, and micro-finance institutions play a significant role in the socio-economic growth of the nations. They do this through intermediating financial resources, risk sharing, and risk diversification. Particularly insurance companies facilitate a nation's innumerable economic transactions through efficient and effective savings mobilization, risk transfer, and indemnification (Mishkin, 2010 and Salvatore, 2013). Hence, the successful insurance sector is fundamental to every modern economy since it encourages savings habits as well as provides a safety net to rural and urban enterprises and productive individuals.

According to Cura and Poposki (2012) as the incidence of losses increased with the advancement of civilization, slowly the idea and concept of loss pool and loss sharing started taking roots. Globally, the history of general insurance can be traced back to early civilization. Accordingly, the general insurance company started earlier time and increased from time to time according to the advancement in civilization. The Mediterranean merchants practiced insurance from as early as the 4th century BC through the issue of bottom bonds, which is an advancement of money in a ship during the period of voyage, repayable on the arrival of the ship. The Code of Manu also indicates the practice of marine insurance by Indians with their counterparts in Sri Lanka, Egypt, and Greece (Pankaj, 2014). So the practice of insurance started when the business concept of the society starts in different parts of the world

Khan (2013) showed that leverage ratio, company size, earnings volatility, and age of the firm are significant determinants of profitability while growth opportunities and liquidity are not significant determinants of profitability cited from the Malaysian banking industry. A study by Ahmed (2008) also examined that the determinants of banks profitability were indicated by the company size, volume of capital, leverage, and loss ratio and these variables are significant determinants of profitability of private banks. Other studies conducted in the area of factors affecting the private bank's profitability (Curak, (2012); Shiu, (2014); Maria and Ghiorghe, (2014) indicated that there is a direct relationship between the profitability of private banks and its both internal (company size, solvency margin, and leverage ratio) and external (Gross Domestic Product, Inflation Rate, Interest Rate) determinants. According to this study, the internal factors affecting the profitability of the private banks are company size, solvency margin, and leverage ratios whereas inflation rate, interest rate, and gross domestic product are the external factors affecting the profitability of the private banks.

Datu (2016) also examined the relationship between firm-specific factors and profitability (ROA). For insurers, profitability is affected by a multitude of factors including actual age of the company, investment earning, capital gains or losses, the scale of policyholder dividends, and federal and state taxes. Hence, not only measuring the profitability of general

insurance companies but also clear insight about factors affecting profitability in the industry is then the problem to be investigated.

Therefore, the factors affecting the profitability of general private banks have not been adequately investigated in Ethiopia in general and particularly in Ethiopia. Thus, the current paper extended prior researches and contributes to the literature on the factors affecting the profitability of general private banks in a number of ways.

The objective of the Study

General Objective of the study

The general objective of this study is to investigate factors affecting the profitability of private banks in Ethiopia.

Specific Objectives

The following are the specific objectives of this study. These are:

- To identify factors affecting the profitability of private banks in Ethiopia.
- To determine the level of relationship between determinant factors and profitability of private banks in Ethiopia.
- To rank the determinants according to their degree of influence on private banks' profitability in Ethiopia.
- To recommend to the concerned bodies the factors affecting the profitability of the private banks in Ethiopia.

Ho1: Solvency ratio has a significant impact on the profitability of private banks in Ethiopia.

Ho2: The growth rate has a significant impact on the profitability of private banks in Ethiopia.

Ho3: Company size has a significant impact on the profitability of private banks in Ethiopia.

Ho4: Gross domestic product (GDP) has a significant impact on the profitability of private banks in Ethiopia.

Ho5: Inflation has a significant impact on the profitability of private banks in Ethiopia.

Ho6: Interest rate has a significant impact on the profitability of private banks in Ethiopia.

II. RESEARCH METHODOLOGY

The main objective of this study was to assess the factors affecting the profitability of private banks in Ethiopia. This study is basically a causal research design study because it shows the cause and effect relationships of the two variables called independent variables (factors) and dependent variables (profitability). For this reason, the researcher employed a causal research design.

A. Target Population

The target population of this study was all private banks registered by NBE which are operating in Ethiopia and which have more than ten years of experience.

B. Source and Type of Data

An only a secondary source of data was used for this study's purposes because this study by nature focuses on the secondary type of the data. For this study's purposes, only quantitative type of data was used since this study focused only on secondary sources of the data. The quantitative type of data includes secondary data from the financial statement like the balance sheet of the private banks operating in Ethiopia.

C. Methods of Data Collection

The secondary source of data was collected from all relevant sources such as books, journal articles, published and unpublished research papers, financial statements of private banks through the report of the National Bank of Ethiopia (NBE).

D. Sample Design and sample size

In order to get the required data for the achievement of this research objective, the researcher conducted a census survey design for ten private banks operating in Ethiopia.

E. Data Analysis Method and Presentation

To analyze the collected secondary data, the researcher used both descriptive and inferential statistical analysis techniques. Under the descriptive statistical analysis techniques, like mean, standard deviation, minimum and maximum were calculated. Under the inferential statistical techniques, Pearson Correlation and linear regression analysis were done. Correlation analysis was used to test the strength of the relationship between independent variables and dependent variables. Finally, linear regression analysis was employed to test the hypotheses of this study.

Tables and graphs were used for analyzed data presentation. Tables were used to present both analysis output of descriptive and inferential statistical analysis whereas graphs like normality test graph or histogram were used to test the normality of the data residual.

III. RESULTS AND DISCUSSION

A. Secondary Data Analysis

a). Descriptive statistics

The table below presents a summary of the descriptive statistics of both dependent and independent variables for the period of ten years data starting from 2008-2017. Key descriptive statistical analysis techniques were used including mean, maximum, minimum, and standard deviation.

Table 4.2: Descriptive Statistics of the Variables

Variables	Minimum	Maximum	Mean	Std. Deviation
Return on Asset	2.00	3.80	2.5745	0.53054
Company Size	5.04	9.71	7.4700	1.11666
Solvency Ratio	1.11	3.29	2.0372	0.59842
Gross Domestic Product	1.10	3.12	1.7771	0.70351
Inflation Rate	1.03	3.16	1.7549	0.53921
Interest Rate	1.10	3.80	2.4567	0.57353

Source: SPSS Output of Financial statements of private banks, 2018

Return on Assets (ROA) was used to measure the profitability of the private banks. As indicated in the above table, the profitability measures (ROA) show that Ethiopian private banks achieved on average a positive before tax profit over the last 10 (2008-2017) years. For the total sample, the overall mean of ROA was 2.57% with a maximum of 3.8 % and a minimum of 2%. That means the most profitable private banks among the sampled earned 3.8 cents of profit before tax for a single birr invested in the assets of the firm. Regarding the standard deviation, it's mean to both sides by 53.4 percent which indicates there was high variation from the mean. This implies that private insurance companies need to optimize the use of their assets to increase the return on their assets.

The logarithm of total assets is used as a proxy to the size of the private banks and its mean of the logarithm of total assets over the period 2008-2017 was 7.47. The size of private banks was highly dispersed from its mean value with a standard deviation of 1.116. The maximum and minimum values of the size of the company were 9.71.29 and 5.04 respectively.

Regarding GDP, the mean value of the real GDP growth rate was 1.777% indicating the average real growth rate of the country's eco of economy was recorded. The standard deviation is 70.35 percent, and a maximum of 3.12 and a minimum of 1.10 percent respectively.

Regarding the inflation rate, the mean score was 1.7549%. This implies that the increase in the inflation rate of the private banks can decrease the Profitability of the Ethiopian private banks. The standard deviation is 53.92 percent, a maximum of 3.16, and a minimum of 1.03 percent respectively.

Finally, another variable employed in this study, time deposit weighted average interest rate, the mean value 2.4567 with the maximum of 3.80 and minimum was 1.10. This indicates that the financial market in the country during the period of 2008-2017 remains stable.

PEARSON CORRELATION ANALYSIS

Correlation measures the degree to which two sets of data are related. A higher correlation value indicates a stronger relationship between both sets of data (Coetzee, 2003). Correlation analysis shows the strength of the association between the variables involved. According to Alwadael, (2010) the value of coefficient correlation between variables 0.70-1.00 very strong correlation, 0.50-0.69 substantial (high) correlation, 0.30-0.49 moderate correlation, 0.10-0.29 low correlation, and 0.01-0.09 negligible correlation.

To find out the relationship between the independent variables and dependent variables, a correlation coefficient was used. The Pearson correlation coefficient analysis shows the correlation between independent variables and dependent variables. The value of the correlation coefficient always ranges from +1 to -1. Correlation coefficient values of +1 indicate a perfectively positive relationship between two variables, while correlation coefficient values of -1 indicate a perfectively negative relationship between two variables. On the other hand, the correlation coefficient value of zero value indicates that there is no linear relationship between the two variables.

Table 4.3: Pearson Correlation

Variables	Return on Asset	Company Size	Solvency Ratio	Gross Domestic Product	Inflation Rate	Interest Rate
Return on Asset	1					
Company Size	0.269	1				
Solvency Ratio	0.865	0.235	1			
Gross Domestic Product	0.859	0.173	0.779	1		
Inflation Rate	-0.872	0.143	0.720	0.791	1	
Interest Rate	-0.316	0.164	0.306	0.405	0.321	1

Source: SPSS Output of the Secondary Data, 2018

Table 4.3 indicates the level of correlation between the dependent variable (Profitability) and independent variables (solvency ratio, company size, and growth rate of GDP, inflation rate, and interest rate). In the above table, solvency ratio, premium growth, company size, the growth rate of GDP of this study are positively correlated with the profitability of private banks in Ethiopia but inflation rate and interest rate are negatively correlated with the profitability of private banks in Ethiopia.

Regression Analysis

Table 4.4: Regression Analysis

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	0.835	0.698	0.650	0.36686	1.737

Source: Own Survey Result, 2018

From the above table, R and R square are 0.835 and 0.698 respectively. R square (0.698) shows the power of the independent variables to predict the dependent variable. It also shows approximately 69.8% of the total variation in the dependent variable is explained by the linear combination of the independent variables. R square indicates the relationship of independents and dependent variables. This indicates a high correlation between these two variables.

Coefficient of determination (R Square) explains the extent to which changes in the dependent variable can be explained by changes in the independent variables or the percentage of variation in the dependent variable (profitability of insurance companies in Ethiopia) that is explained by all the eight independent variables.

Therefore, the researcher found that independent variables share 69.8% of profitability in Ethiopia according to the study. This means that 30.2% of the factors affecting profitability are not explained in this study. The adjusted R2 value shows the loss of predictive power. This value implies how much variance in profitability is accounted for if the model had been derived from the population from which the sample was taken.

According to Durbin and Watson (1950), Durbin-Watson tests the correlation between errors. The Durbin-Watson tests autocorrelation. It tests first-order autocorrelation in regression residuals. The test statistics can vary between 0 and 4. The Durbin-Watson statistics value close to 2 shows that the residuals are unrelated.

Table 4.5: ANOVA (Analysis of Variance)

Model	Sum of Squares	Df	Mean Square	F	Sig.
Regression	15.595	8	1.949	98.231	0.000
Residual	1.012	51	0.020		
Total	16.607	59			

The highest value of "F" shows that the regression model is a good fit for the data. Table 4.5 shows that the independent variable is statistically significant to predict the dependent variable, $F = 98.231$, $p < 0.05$. Therefore, the regression model is a good fit for the data. Since F calculated is greater than the F critical, this means that the overall model was significant, and hence, it is good for prediction.

Table 4.6: Predicting Profitability by Regression Model

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	0.743	0.146		5.074	0.000		
Company Size	0.004	0.019	0.009	0.221	**0.826**	0.761	1.315
Solvency Ratio	0.151	0.060	0.171	2.529	0.015	0.262	3.812
Gross Domestic Product	0.156	0.051	0.206	3.064	0.003	0.263	3.801
Inflation Rate	-0.260	0.067	0.264	-3.868	0.000	0.257	3.894
Interest Rate	-0.042	0.037	-0.046	-1.126	**0.265**	0.730	1.371

Source: Own Survey Result, 2018

From table 21, the β-value or the coefficient of the independent variables indicates to what extent the independent variables affect the dependent variable of this study.

The above coefficient table shows that there is a relationship between independent variables and dependent variables. The coefficient values of these independent variables are the solvency ratio (0.151), company size (0.004), the growth rate of GDP (0.156), inflation rate (-0.260), and interest rate (-0.042). This shows that the inflation rate and interest rate have a negative relationship with the profitability of the private banks in Ethiopia. This implies that for example, But solvency ratio, company size, and growth rate of GDP have a positive relationship with the profitability of the private banks in Ethiopia. . This implies that for example when the company size

of the private banks is large, the profitability of the private bank's increases. The same is true for all independent variables that have a positive relationship with dependent variables.

The t-test or t-value measures whether the predictor is making a significant contribution or not to the model. The t-values of the variable under consideration are as follows. These are the solvency ratio (0.015), premium growth (3.328), company size (0.221), the growth rate of GDP (3.064), inflation rate (-3.868), and interest rate (-1.126). From this, it can be concluded that gross domestic product has the highest impact on the profitability of the private banks in Ethiopia. Out of the independent variables, solvency ratio and company size have the lowest impact on the profitability of the private banks in Ethiopia.

From the above table, the significance value shows the solvency ratio (0.015), premium growth (0.002), company size (0.826), the growth rate of GDP (0.003), inflation rate (0.000), and interest rate (0.265). If the p-value (calculated value) is less than 0.05 (table value), then that variable is significant unless it is insignificant since the p-value is less than 0.05. According to the above table under the significance column, the company size, and interest rate have no significant effect on the profitability of the private banks in Ethiopia since the p-value is greater than 0.05. But solvency ratio, the growth rate of GDP, inflation rate, have a significant effect on the profitability of the insurance private banks in Ethiopia since the p-value is less than 0.05.

According to O'brien (2007), the tolerance value for all independent variables which is less than 1, and VIF which is less than 10 is considered acceptable. The above table shows that the value of tolerance of independent variables of this study ranges from 0.257 to 0.761 and VIF is less than 10 shows that there it is in the acceptable range.

Hypothesis Testing

In this study, there are eight hypotheses (H1-H8). The hypotheses testing of this study are discussed below based on the significance value.

Table 4.7: Hypothesis Testing of the Independent Variables

Hypothesis	Types of Hypothesis	p-value	Result
H_1	Solvency ratio has significant impact on profitability of private banks in Ethiopia.	0. 015<0.05	Accepted
H_2	Company size has significant impact on profitability of private banks in Ethiopia.	**0. 826**<0.05	**Rejected**
H_3	Gross domestic product has significant impact on profitability of private banks in Ethiopia.	0. 003<0.05	Accepted
H_4	Inflation has significant impact on profitability of private banks in Ethiopia.	0.000<0.05	Accepted
H_5	Interest rate has significant impact on profitability of private banks in Ethiopia.	**0. 265**<0.05	**Rejected**

Source: Own Survey Result, 2018

Based on the above factors affecting the Profitability of the insurance companies in Ethiopia, the researcher tested the hypotheses of this study as follows:

H1: The solvency ratio has a significant impact on the profitability of private banks in Ethiopia.

H2: Company size has no significant impact on the profitability of private banks in Ethiopia.

H3: Gross domestic product has a significant impact on the profitability of private banks in Ethiopia.

H4: Inflation has a significant impact on the profitability of private banks in Ethiopia.

H5: Interest rates have no significant impact on the profitability of private banks in Ethiopia.

In general, the company size and interest rate have no significant effect on the profitability of the private banks in Ethiopia. But solvency ratio, the growth rate of GDP, inflation rate, and interest rate have a significant effect on the profitability of the private banks in Ethiopia.

IV. CONCLUSION AND RECOMMENDATIONS

A. Conclusion

private banks play a significant role in a country's economic growth and offer financial protection to an individual or firm against monetary losses suffered from unforeseen circumstances. Therefore, in order to survive negative shocks and maintain good financial stability, it is important to identify the determinants that mostly influence the private bank's profitability. To this end, this study aimed at examining possible factors i.e. firm-specific and macro-economic factors that can affect private banks profitability in Ethiopia and to what extent these determinants exert impact on company profitability.

All private banks are selected as a sample from Ethiopia currently operating in Ethiopia. In the

study solvency ratio, company size, GDP, inflation, and interest rate are considered as independent variables while return on asset (profitability) is considered as the dependent variable. The empirical findings on the effect of private banks' profitability in Ethiopia for the sample suggested the following conclusions.

On the other hand, inflation has negatively related to profitability but the influence was statically insignificant. Interest rate which is measured by time deposit weighted average was omitted from the model, may this result of the interest rate does not significantly vary from time to time in Ethiopia.

B. Recommendations

On the basis of the findings of this study, the researcher has drawn the following recommendations on the basis of analysis of secondary data:

Secondly, to reduce the number of losses the company should also increase claims handling practice with continuous improvement on claim linkage management on both sides, which is from the company employee (the engendering, inspection, and claim management department) and from the customer side, to do this the company should develop immediate investigation mechanism on a reported claim with crossed confirmation mechanism, for the employee, when conducting post-risk assessment the employee should report online picture and video to confirm the post-risk assessment. Therefore, he/she send the back office assessor or database from the claim site at a time, for the customer, the claim report or declaration day should reasonably limit to notice the loss. This mechanism helps the company to know the genuine of the claim and its assessment.

private banks should increase their company asset. An increase in total assets such as the establishment of more branches and the adoption of new technologies enables private banks to issue more policies which may increase the profitability and the total net profit. In addition, increasing assets like a branch and toying crane also minimize the cost of a claim.

Finally, the study sought to investigate the determinant of profitability in private banks' in Ethiopia. However, the variables used in the statistical analysis did not include all factors that can affect the profitability of private banks in Ethiopia. It only includes a few firm-specific and macro-economic variables. Thus, future research shall conduct on an issue like the impact of government regulatory policy and other directives and non-financial determinants of private banks' profitability such as management quality, efficiency and productivity and etc.

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