Research Paper

Macroeconomic and micro variables influencing profitability of nepalese commercial banks

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ABSTRACT

The study intends to investigate the effect of micro and macro variables on the profitability of Nepalese commercial banks. 81 observations of 9 commercial banks from fiscal year 2012/13 to 2020/21 were taken for analysis. Return on Assets (ROA) was taken as the dependent variable. Capital adequacy ratio, non-performing loan ratio, loans and advances ratio, deposit ratio and bank size were taken as bank specific micro variable while gross domestic production, inflation rate and real interest rate were taken as macro variables to determine their influence on profitability. Descriptive and casual comparative research design was used to conduct the study using correlation, regression model and ANOVA test. The findings of the study revealed that there is positive and significant impact of CAR, LAR, bank size, GDP, inflation rate and interest rate on bank profitability. Where as non-performing loan has positive insignificant relationship and deposit ratio has negative insignificant relationship with ROA.

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1. INTRODUCTION

Nepal, a low and middle-income country, is attempting to take a step in the advancement of its economy by developing all sectors of its economy. Even though the economic development process depends on various factors, proper utilization of financial resources or capital plays an important role in the health of the economy. There is a crucial role of financial institutions in economic enhancement, deploying monetary resources, recognizing valuable and beneficial projects, supervising top level managers and boosting their skills. Nepal Rastra Bank regulates the financial sectors as the central bank of Nepal. Banking is a kind of commercial operation related to accepting and protecting funds possessed by other entities and lending out these funds in the market to operate financial transactions. Therefore, banks are one of the key financial intermediaries which collect scattered capital from the masses and invest it into economic activities in the nation. They are primarily responsible being financial intermediaries for making financial services accessible to the market [1]. They facilitate allocating funds from savers to investors. The financial system of any nation relies upon the banking system, so the returns of banks is crucial for economic growth [2]. Profitability is an essential component for widening and expanding banking sectors, which need to focus on contemporary issues of bank profitability [3], [4].

Bank profitability has been affected by both internal micro and external macro indicators. It fluctuates depending on both micro and macro variables. Internal micro variables are also known as bank (industry) specific determinants and are controlled by management, which include non-performing loans, loans and advances, capital adequacy, deposits, bank size, etc. In contrast, the determinants that are beyond the control of management and not associated with internal operation, which include GDP, interest rate, tax rate, inflation rate, market price, etc. Banks should amend their management policy from time to time concerning to the macro environment to maximize their return.

1.1 Statement of Problem

The banking sector is vital to the world economy [5]. Banking in Nepal is in the process of being systematized [6]. Globally, banks are progressing and enhancing their banking activities, but in the context of Nepalese commercial banks, they have not achieved satisfactory results and successful operations [7]. Due to lack of banking professionalism, absence of strong supervision, destructive and tough competition, political uncertainty, quantitative setup instead of qualitative system, weak willingness in saving habit, city focused financial plans, increase in digital fraud, absence of sufficient advance technology and competent human resources, low profitable investment and traditional banking practice, lack of financial literacy, Nepalese banks are facing issues on operating financial operation and on generating profit properly. Some of the financial institutions have reached the state of collapse because of the problems related to profitability, so the profitability of banks is becoming the subject of significant concern in the present context [8]. As NRB has been introducing various policies targeted at financial performance, including the profitability of the Nepalese banking sector, and the impact of such policies on the target hasn't been seriously monitored, the research would hence be the first study on the effectiveness of such policies in the real banking world. An economy having a successful and profit-making banking system is strongly capable of holding out against negative impact and providing support to the steadiness of the financial system [9]. Banks are exposed to uncertainties and risks. Risk and return have a positive relationship, which means the higher the risk, the higher the return. The financial operations of banks are mainly influenced by their activities performed within the organization (internal determinants) and the overall state of the economy (external determinants) [10]. Capital adequacy ratio is an internal bank-specific factor which affects the profitability of banks. For small-sized banks, there is a positive influence of capital adequacy ratio on return on assets, whereas for large-sized banks, there is no influence of capital adequacy ratio on return on assets [11]. The regulatory authority should encourage bank capital reinforcement and continuous bank ownership restructuring. NPL can be an indicator of the beginning of a banking crisis as it adversely affects the economic strength of the nation by reducing credit growth [12]. A low level of NPL indicates a sound financial system. In contrast, a high NPL can indicate a vulnerable financial system and affect individual commercial banks. In the long run, it ultimately ruins the financial system and the economy of the entire nation, which can also bring bankruptcy problems. Similarly, another bank-specific factor, the deposit ratio, has a significant relationship with bank profitability. There is a positive and significant correlation of bank deposits, such as fixed deposits, savings deposits, and current deposits, with ROA [13]. And there is a significant effect of bank size on bank profitability, too. Banks having small or medium size exhibit greater performance in comparison with banks having large size, so profitability and the volume of banks have a reverse relationship [14]. Various external macroeconomic factors also affect the profitability of banks. There is a positive and significant relation between money supply and profitability measured by return on equity, and a negative and significant influence of exchange rate and interest rate on return on equity [15]. The profitability of banks influences overall economic development. As policymakers are worried about banks with low profits, it is reasonable to question whether there is a positive contribution of bank profitability to amplify development [16].

Therefore, analyzing the determinants of bank profitability becomes an issue for banks. Banks must be aware of the indicators which create a significant impact on their overall performance for their success. There are not many studies conducted on the factors influencing the profitability of banks in Nepal. So, in order to manage and analyse the effects of micro as well as macroeconomic indicators as factors affecting profitability properly, we must acknowledge the impact of those indicators on the profitability of banks.

2. RELATED WORK

2.1 Profitability

Profitability is defined as a measure of an organization's profit relative to its expenses. Commercial banks are financial institutions that are intended to earn profit. They established by issuing shares to the general public and allowing the public to purchase shares from banks to earn dividends as profit. So profitability can also be taken as the essential foundation to make an investment, too. Increase in profitability ensures a sustainable banking system, which indicates financial development and economic growth at the micro and macro levels [17], [2]. Financial intermediaries with profit positively contribute to the Gross Domestic Production of a nation. There are frequently changing macroeconomic factors that have an impact on the profitability of banks, which need to be analyzed properly [18]. Banks with low profit undermine their interest in financing the broader economy [19]. A growing banking system is important to boost a nation’s economic development, and the profitability of the banking system is crucial for its effective operation, as it assists in maintaining stability by offsetting losses from banking activity. That is why it is essential to identify the determinants that influence bank profitability [20]. Banks must generate adequate profit to cover all costs for day-to-day operations, and their expansion, along with distributing dividends to shareholders. So they should invest their fund in such sectors, which assure a higher rate of return.

2.2 Return on Asset (ROA)

ROA measures the extensive efficacy of a firm in making returns with its accessible resources (assets). In this study, it is the dependent variable used as a proxy of profitability and is determined from net income divided by total assets.

2.3 Capital Adequacy Ratio (CAR)

It measures the capital position of a bank with respect to its exposure to total risk. It is determined from the total capital fund divided by the total risk-weighted assets.

2.4 Non-Performing Loan Ratio (NPLR)

NPLR is a measurement of credit risk of a bank. It is defined as a loan which the borrower hasn’t any schedule payment of principle and interest for some time. It is calculated dividing non performing loan by total loan.

2.5 Loan and Advance Ratio (LAR)

It measures total loan outstanding as a percentage of total assets. A higher level of loans generates higher profits for the bank. LAR is determined from the total loans and advances divided by total assets.

2.6 Deposit Ratio (DR)

Deposits are the main source of funds collected at the lowest cost for the bank. Deposits ratio measures how much of its funds a bank has as deposits compared with how much of its funds it has as capital or assets. The higher the deposits converted into loans, the higher the margin in profitability. DR is determined from total deposits divided by total assets.

2.7 Bank size

Bank size represents the total ownership of assets by banks. We scale it by using logarithm of asset.

2.8 Gross Domestic Production (GDP)

Gross Domestic Production can be measured as the sum of value added created through the production of goods and services in the economy or the value of final goods and services which are produced to be sold (less imports).

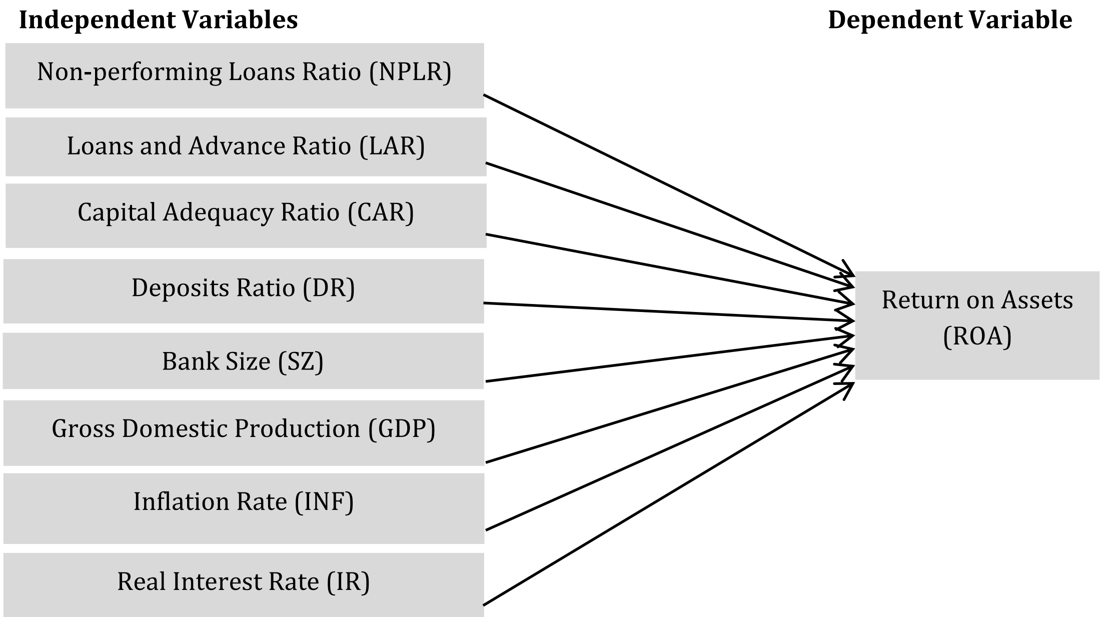
2.9 Inflation

Inflation refers to the decline of purchasing power of money, which occurs due to an increase in the average price level of selected goods and services.

2.10 Real Interest Rate

Real interest rate can be adjusted for inflation, which reflects the real cost and return of the fund to the borrower, investor, or saver accordingly.

2.11 Research Framework



Note: Adopted from [21]

Figure 1. Research Framework

As shown in Figure 1, the theoretical framework has displayed independent variables non-performing loan, loan & advances, capital adequacy, deposits, banks size, GDP, inflation rate, and real interest rate to examine the dependent variable return on assets.

3. METHODOLOGY

3.1 Research Design

Research methodology assists us in solving the research problems in a systematic way. Research design is an elaborated framework which includes a group of decisions about how the research will be performed, such as what topic, with what method, among what population, for what motive the study is to be done, etc. It is a plan to execute the research problem that has been formulated. It is a structure and strategy of investigation concerted so as to obtain answers to research questions and to control variance. Keeping in mind the objective of the study, descriptive and causal comparative research design with secondary data has been used to analyze the factors affecting bank profitability. This research design is used to test how and why the capital adequacy ratio, deposits, loans and advances, volume of bank, non-performing loans ratio, GDP, inflation rate and real rate of interest will affect bank profitability of sample banks from 2012/13 to 2020/21.

3.2 Population, Sample and Sampling Design

A population indicates a set of elements or a group which is going to be examined. A target population of the research includes a group that the researcher aims to cover in the study, developed from findings. While conducting research, investigating several elements, collecting data from, and testing or examining every element would be difficult. So sampling is the procedure of choosing a small number of samples from the entire target population. All commercial banks licensed by NRB comprises the target population for this research. Out of those banks, only nine banks that are listed in NEPSE and represent both private ownership and government ownership are taken as the sample for this study, using purposive non-probability sampling. This sample covers 33.33% of the target population.

3.3 Method of Data Analysis

Data analysis includes the methods for determining population parameters, examining hypotheses and making predictions. To support the reliability, authenticity, effectiveness and convenience of the analysis, different kinds of financial, accounting and statistical tools are employed. The analysis was conducted depending on the available pattern of data, considering the availability of time and resources too. Financial analysis consists of ratio analysis along with statistical tools such as the coefficient of correlation, regression, and hypothesis testing, which are used in this research.

3.4 Model Specification

The model of the research presumes that the overall performance of commercial banks is denoted by return on assets (ROA) as dependent determinant depends on various independent determinants such as capital adequacy ratio (CAR), deposit ratio (DR), loans and advances ratio (LAR), nonperforming loans ratio (NPLR), size of bank, gross domestic production (GDP), rate of inflation and rate of real interest. Following panel data ordinary least squares regression model is used to determine the influence of those mentioned determinants on the overall financial effectiveness of Nepalese commercial banks.

$ROA = \beta 0 + \beta 1CAR + \beta 2\ NPLR + \beta 3\ LAR + \beta 4DR + \beta 5SZ + \beta 6GDP + \beta 7INF + \beta 8IR + \mathcal{E}$

Where,

$\beta 0$ = Constant variable/intercept of dependent variable

$\beta 1, \beta 2, \beta 3 \ldots \beta 8$ = coefficient of independent variables that affect the behaviour of dependent variable

$\mathcal{E}$ = Error terms As shown in Figure 2, samples banks with study period for 9 years has been displayed.

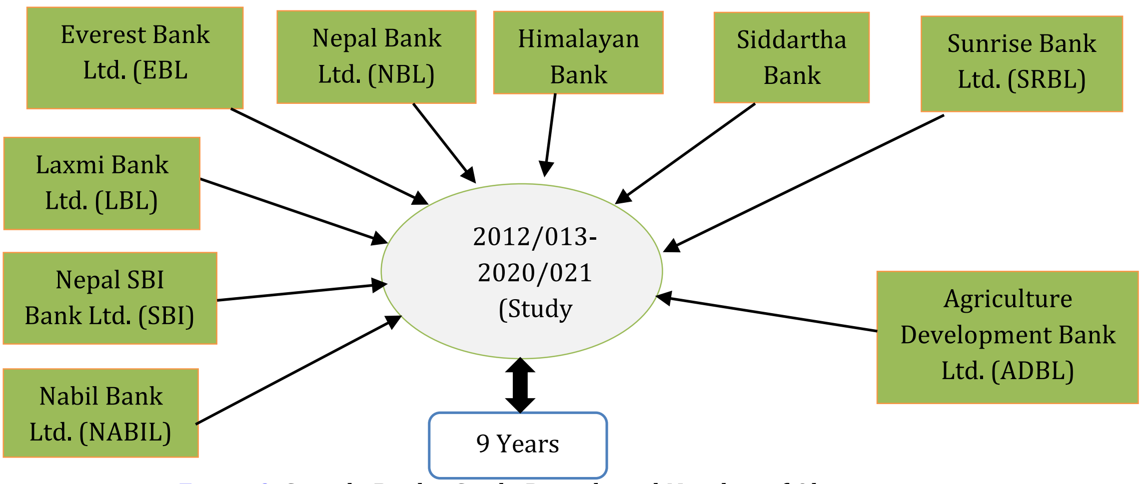


Figure 2. Sample Banks, Study Periods and Number of Observation

1. Return on Asset → Net Profit / Total Assets
2. Capital Adequacy Ratio → Total Capital / Total Risk-weighted Assets
3. Loans and Advances Ratio → Total Loan&Advances / Total Assets
4. Non-performing Loan Ratio → Non-performing Loans / Total Assets
5. Deposits Ratio → Total Deposits / Total Assets
6. Bank Size → Log of Total Assets
7. Gross Domestic Production → Gross Domestic Production Growth Rate
8. Inflation Rate → Consumer Price Inflation Rate
9. Interest Rate → Real Rate of Interest

Figure 3. Variables and is Measurements

As shown in Figure 3, every internal variables and its measurements in ratio is displayed which represent how we can calculate those variables.

4. RESULTS AND DISCUSSION

Table 1. Descriptive Statistic

Variables	N	Minimum	Maximum	Mean	Standard Deviation
Return On Assets	81	.55	3.25	1.7363	.57436
Capital Adequacy Ratio	81	-.59	20.41	13.0669	2.99755
Non-performing Loan Ratio	81	.10	5.85	1.7756	1.48864
Deposit Ratio	81	68.33	90.93	82.0254	5.55202
Loan and Advance Ratio	81	44.43	74.92	66.6270	6.34053
Bank Size	81	17.08	19.49	18.4194	.52753
Gross Domestic Production	81	-2.09	8.98	4.1023	3.41696
Inflation Rate	81	3.60	9.04	6.2191	2.17139
Real Interest Rate	81	5.00	8.00	6.9444	0.96177

As shown in Table 1, the main source of bank profitability(average performance) of bank, ROA has found to be 1.7363% on average over entire time period with minimum 0.55%, maximum of 3.25% and volatility ratio (standard deviation of ROA) 0.57436%. The average CAR is 13.0669% with minimum, maximum and standard deviation is 0.59%, 20.41% and 2.99755% respectively. The average credit risk measured by non-performing loan ratio (NPLR) is 1.7756% with minimum, maximum and variation measured by SD is 0.10%, 5.85% and 1.48864% respectively. Similarly, average DR, LAR and size of bank is 82.0254%, 66.6270% and 18.4194% respectively. The macroeconomic variable GDP. Inflation rate and interest rate is 4.1023%, 6.2191% and 6.9444% respectively.

Table 2. Correlation Analysis

		ROA	CAR	NPLR	DR	LAR	SZ	GDP	INF	IR
ROA	Pearson Correlation	1								
CAR	Pearson Correlation	.301**	1							

NPLR	Pearson Correlation	0.163	-0.037	1						
DR	Pearson Correlation	-0.081	-.544**	0.003	1					
LAR	Pearson Correlation	0.036	.352**	-0.204	-0.203	1				
SZ	Pearson Correlation	0.133	.365**	-.246*	-.654**	0.053	1			
GDP	Pearson Correlation	.286**	-0.014	0.072	0.029	0.062	-0.192	1		
INF	Pearson Correlation	0.05	-.403**	.326**	.605**	-.395**	-.672**	-.240*	1	
IR	Pearson Correlation	0.216	-.356**	.382**	.630**	-.363**	-.779**	.367**	.719**	1

* Correlation is significant at 0.01 level (2-tailed).
* Correlation is significant at 0.05 level (2-tailed).

As shown in Table 2, the result from correlation represents that all the independent variables except DR namely CAR, NPLR, LAR, SZ have weak positive relationship with ROA while DR is significantly negatively related with ROA. The external factors GDP, INF and IR have also positive relationship with ROA. Which indicates increase or decrease in CAR, NPLR, LAR, SZ, GDP, INF, and IR would be positive significantly related to increase or decrease in ROA of sample banks while higher the amount of deposits, lower the profitability of sample banks.

Table 3. Regression Coefficient

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta	-5.538	<.001
1	(Constant)	-24.395	4.405		2.933	.005
	Capital Adequacy Ratio	.060	.021	.314	.343	.733
	Non-performing Loan Ratio	.013	.038	.034	.353	.725
	Deposit Ratio	.005	.014	.049	2.814	.006
	Loan and Advance Ratio	.028	.010	.311	5.849	<.001
	Bank Size	1.046	.179	.960	2.300	.024
	Gross Domestic Production	.057	.025	.339	2.587	.012
	Inflation Rate	.138	.053	.521	2.654	.010
	Real Interest Rate	.386	.145	.646		
	R	.705				
	R square	.497				
	Significant level	<.001				

As shown in Table 3, R has a value of 0.705 that denotes all independent indicators have strong positive correlation with dependent indicator. Furthermore, R-square has a value of 0.497, that indicates all independent variables namely CAR, NPLR, LAR, DR, SZ, GDP, INF, IR explain 49.7% of the variation to depending variable, and 50.3% of the variant is described ed by other variables. Similarly, P-value (<0.001) is less than that significance level value (.05) and F-statistic is significant at 5 percent significant level which means the model used in this study to show the effect is accepted. Our regression model is statistically significant as null hypothesis is rejected and the alternative hypothesis is accepted i.e. the internal and the external factors have a significant relationship with profitability of bank. Furthermore, the profitability of Nepalese commercial banks in respect of ROA is positively influenced by capital adequacy ratio, loans and advances ratio, bank size, annul GDP growth rate, inflation rate and real rate of interest with value of p less than 0.05 while non-performing loans and deposits ratio have not impact on bank profitability because p-value of these variables is more than 0.05.

Discussion

The findings of the study suggest that all micro and macro variables, namely, CAR, LAR, SZ, GDP, INF, and IR, have a positive and significant impact on bank profitability, but there is no significant relationship between DR and NPLR with the profitability of Nepalese commercial banks. But [22] argue that capital adequacy, deposits ratio, operational efficiency and almost external variables have a negative and significant influence on ROA. He studies 37 commercial banks listed on the Bombay Stock Exchange, India, to examine the influence of internal and external environmental factors on profitability. This could also be applicable for the Nepalese banking sector due to various reasons such as poor management of banks, government instability, etc. In March 2011, another investigation was done on factors affecting profitability in Pakistan and found that there is a significant impact of all micro and macro variables on the profitability of banks in Pakistan. Banks having greater equity, total assets, deposits, loans and various macro indicators such as stock market capitalization, economic growth, are more secure, and this benefit can lead to more profitability [23].

The loan and advance, current deposit, and gross domestic product have a statistically significant and positive relationship with banks' profitability, while variables like fixed deposit and market concentration have a negative and statistically significant relationship with banks' profitability in the Ethiopian banking industry [24]. [21] Examines the internal determinants (bank-specific characteristics) and external determinants (macroeconomic factors and government variables) of bank profitability in 18 banks in Iraq. The results show that most bank-specific, economic and government-related indicators, such as total loan to total assets, total equity to total assets, size of banks, GDP growth rate, and government effectiveness, have statistically significant effects on the performance of commercial banks in Iraq. Whereas, interest rate, inflation rate, credit default risk, unstable politics, and unemployment have a significant negative impact on the performance of Iraqi banks. However, the economic growth of developing nations, including Nepal, is heavily dependent upon the effective operation of financing, especially banking sectors, and the central bank has a leading contribution in formulating countrywide regulations, guiding and leading financial sectors to execute them and upgrading banks' performance.

5. CONCLUSION

A vigorous financial system is essential for a prosperous and sound economy. The banking sector can be taken as a key element of the financial service industry. On the other hand, the success of a nation mainly relies on the successful operation of its banks. In our nation, the banking industry has made an important contribution to financial activities and economic development. The stability of the banking sector is becoming a major issue for policymakers, central banking authorities, supervisors, managers and so on. Various sectors and so many elements could affect the future profitability of the banking industry. To meet the objectives of this study, the analysis of panel data coefficient of correlation analysis, regression model, coefficient of variation analysis, and ANOVA test is applied. Using ROA as a measure of bank profitability, it was found that the internal micro factors, namely capital adequacy ratio, deposit ratio, loans and advances ratio, and bank size, have a significant effect on bank profitability, whereas the non-performing loans ratio has no significant effect on the profitability of Nepalese commercial banks. Similarly, external variables such as interest rates, inflation rates, and GDP also have a positive and significant effect on profitability. Among those internal and external variables, the deposit ratio and NPLR are statistically insignificant, while other variables are statistically significant.

This study also concluded that the major influencing determinants of bank profitability are bank size, inflation rate and real interest rate. Bank size has a higher impact on bank profitability in comparison with other variables. The large-sized banks are shown with a higher level of profitability. We can say that large-sized banks have higher diversification and economies of scale, which lead to higher profitability. So banks should mainly consider economies of scale through product diversification, expanding market geographically and focus on mergers and acquisitions to expand bank size. Except for bank size, macroeconomic variables have a higher impact on bank profitability than bank-specific micro variables. Therefore, banks should consider internal bank-specific as well as external macroeconomic variables by following NRB directives and policies to ensure sound financial health.

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Author Contributions Statement

Name of Author	C	M	So	Va	Fo	I	R	D	O	E	Vi	Su	P	Fu
Pratibha Gyawali	✓		✓	✓		✓		✓	✓	✓	✓			✓
Tank Prasad Neupane		✓				✓	✓	✓		✓	✓	✓	✓	

C : **C**onceptualization	I : **I**nvestigation	Vi : **Vi**sualization
M : **M**ethodology	R : **R**esources	Su : **Su**pervision
So : **So**ftware	D : **D**ata Curation	P : **P**roject administration
Va : **Va**lidation	O : Writing - **O**riginal Draft	Fu : **Fu**nding acquisition
Fo : **Fo**rmal analysis	E : Writing - Review & **E**diting	

Conflict of Interest Statement

We authors hereby declare that we both do not have any conflict of interests related to the subject matters discussed in this research "Macroeconomic and Micro Variables Influencing Profitability of Nepalese Commercial Banks".

Informed Consent

We Pratibha Gyawali corresponding author and Mr. Tank Prasad Neupane hereby offer our free consent to the publisher to publish our data and our information as per the norms concerned to our paper "Macroeconomic and Micro Variables Influencing Profitability of Nepalese Commercial Banks".

Ethical Approval

We Pratibha Gyawali corresponding author and Tank Prasad Neupane hereby ensure that the research paper "Macroeconomic and Micro Variables Influencing Profitability of Nepalese Commercial Banks" was conducted without involving of sensitive data related to human or animal. We hereby declare that the research was conducted in accordance with ethical standard for the use of secondary data. We are assuring our commitment to highest degree of approval to the publisher.

Data Availability

We Pratibha Gyawali corresponding author and Tank Prasad Neupane hereby declare that the data used in this study were collected from publicly accessible sources on the official website of commercial banks in Nepal during the period 2012 - 2021, NRB bulletins, NEPSE Report, various surveys published by Government of Nepal, ministry of finance, website of World Bank and Statista. All data are secondary in Nature.

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