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Bank's Profitability – a Case Study Guyana

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Abstract

The banking sector is the core segment of the financial system which can articulate a country's economic progress. Further banks play an important role in the mobilization and allocation of financial resources in an economy. The soundness of financial position of a bank adds confidence to all financial participants and equally important for the country's economy. In recent decades and relative to Guyana, banks have undergone extensive transformations brought about by the evolution of the contemporary economy, the behavior of recipients of banking services, the policies pursued by Governments over the banking sector and the progress of modern technology. In this paper quantitative and qualitative analysis on Return of Assets (ROA) and Return on Equity (ROE) are completed for the top three commercial banks with the highest levels of asset holdings in Guyana from years 2010 to 2017. They are Republic Bank Guyana Limited, Guyana Bank for Trade and industry limited and The Bank of Nova Scotia. This study is further diagnostic and exploratory in nature and makes use of secondary data and conclusion drawn provides that whilst these banks are profitable, management of its expenses must be a long-term strategic objective to manage effectively as margins are shrieking and further importantly to sustained market share and revenues horizon.

Keywords: *Return on Assets (ROA), Return on Equity (ROE), Commercial banks & Profitability.*

Introduction

Banking industry plays a crucial role in ensuring the stability of an economy as banks are regarded as the central part of financial system. The stability and soundness position of banks creates an environment of high economic growth and leads to the development of the economy. Most recently attention to profitability of banks has been on high agenda from regulators and more so the measurement of returns for all shareholders and the increase value to the financial system. The financial performance of banks is generally analyzed with the use of financial ratios and these ratios measure the financial health of banks given the elevated level of risk associated. Therefore, careful attention should be given to the financial performance of these banks in the current scenario in determining their long horizon sustainability and performances.

Profitability has been widely examined as a performance measure of the banking sector in developed countries (Sufian & Habibullah, 2010). The widely used indicators to assess commercial banks performance are return on total assets (ROA) and return on total equity (ROE). Over the past several years, an increased attention regarding performance analysis has been received by financial institutions particularly commercial banks. As a result, the research's focus has been shifted from characterizing performance in simple ratios as ROA or ROE to a multidimensional systems perspective. According to Seiford and Zhu (1999), although important and relevant information about bank financial performance can be provided by accounting and financial ratios, research on assessing the relationships between financial factors and bank performance has to be extended. To assist improving bank productivity, the influence of financial factors namely net interest income, non-interest income and operating expenses measured against total income is relative to ROA and ROE. Further, holistically the existence of banking

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system problems and the increase in the financial sector measures, limited or inadequate analyses have been done to conclude all the determinants of bank performance (Sayilgan & Yildirim).

Problem statement

Profitability is the basic aim of establishing business and banks are not exceptions. As profitability is an important factor for the smooth running of any business in today's competitive setting and it has a significant impact on the performance of the institutions, as the financial proficiency of banks can also influence the economic development. So, to identify profit determinants provide an opportunity to know which variable's influencing banks profit, management can concentrate their attention on it at the time decision making to adjust the factors. Besides, banks bankruptcies can link systematic crunch. Economic sector that has well established banking setup can also subsidize to the solidity of the financial system within boundaries of the countries. Over the preceding 30 years most of the researcher's dedicated considerable time and money in the importance of the commercial variables and various studies have linked variables. All this points to the significance of variables that we are going to conduct study. To conduct a study about the determinants of the profitability of banks not only important for the proprietor but also for the decision makers to access and modify the performance of the banks accordingly to enhance their efficiency and profit describes by. (E. C. Mamatzakis, & Remoundos, P. C., 2003).

Literature review

Economic profitability (ROA-Return to assets)

Represents ratio of net profits and total assets of the Bank. Expressed so net profit on a monetary unit of active, giving an overall assessment of the profitability of the Bank. In American literature, it is known as the return on assets or return on investment and return on invested capital is measured in the Bank or the effectiveness of asset management

Financial profitability (ROE-Return on equity)

ROE is defined as the ratio between net profit and total capital, measuring profitability of shareholders ' investments, putting net profit brought by a monetary unit of capital.

Profitability influenced by financial factors

ROA and ROE indicators have been used by bank regulators and analysts to measure bank profitability, assess performance and predict market's structure trend. They are used as statistical model inputs to forecast bank failures and mergers and for many purposes where a profitability measure is required (Gilbert & Wheelock, 2007).

Banking profitability can be looked at through ROE and ROA (Srairi, 2009) which are the most general ratios used in presenting banks performance. Central banks as supervisory authorities use those indicators in measuring profitability (Athanasoglou et al., 2008). Empirical studies on banking performance have widely focused on ROA and ROE ratios.

Obaid and Alzaabi (2011) concluded that financial ratios are considered as the most frequently tool used for analyzing the financial performance. The financial performance of a firm is revealed by analyzing the financial statement and the possible reasons for decreasing financial performance can be found. Financial ratios are generally used by the users of financial statements such as investors, creditors, lenders, stakeholders and other users who can face considerable losses due to business failure.

Conclusion drawn that the high bank profitability during these years 1999-2009 is associated with a large percentage of loans in total assets, a high proportion of customer deposits, good efficiency and a low doubtful assets ratio. In addition, higher capital ratios also increase the bank's return, but only when return on assets (ROA) is used as the profitability measure. (Trujillo-Ponce, Antonio, 2013).

A study conducted on the Latvian commercial banks in the period from 2006 to 2011 and on the basis of the obtained results, the authors have concluded that profitability has had a positive effect on operational efficiency, portfolio composition and management, while it has had a negative effect on the capital and credit risks, as measured according to ROA, while according to ROE, positive influence is exerted on composition of the capital portfolio and negative - on operational efficiency and credit risk on the profitability indicators of the Latvian commercial banks. (Erina, Jana; Lace, Natalja et al, 2013)

Nagamani and Willaths (2015) explained that the banking sector is considered the back bone of every economy. The assessment of the financial position of banks is vital because these conditions determines the health of the economy.

Trivedi et al (2015) found that the financial performance of banks has become a matter of concern for the external and internal users of financial statements. For analyzing the financial performance of firms, the financial reports and statements acts as an indicator to ascertain the stability of a business. The matters related to measuring the bank's performance are complicated and critical because of the diversified role played by banks in the economy.

Other determinants on ROA and ROE

Testing 80 countries for the period 1988-1995, Demirguc-Kunt and Huizinga (1999) concluded that both capital adequacy and foreign ownership have positively affected ROA. Capital adequacy ratio has positively affected ROE for period 1992-1998 in Italy, Denmark, Germany, England, France and Spain banking sectors (Goddard et al., 2004a).

Kaya (2002) also found that capital ratio has positively affected ROA and negatively affected ROE. In addition, Abreu and Mendes (2002) examined banks of Spain, France, Portugal and Germany and for the period 1986-1999 and concluded that there was a positive influence of capital ratios on both ROA and ROE. Athanasoglou et al. (2008) found a positive and significant influence of capital on assets ratio on profitability in Greek banks for the period 1985-2001. This influence was only half of the influence that was found in Australian, North American and European banks (Bourke, 1989) and in European banking industry (Molyneux & Thornton, 1992). In Turkish banking sector, capital ratio has a positive influence on ROA and ROE in the period 2002-2007 (Sayilgan & Yildirim, 2009). Sufian (2011) analyzed the Korean banking profitability in terms of ROA and ROE over the period 1992-2003 and he found that capital ratio was positively and significantly related to profitability.

Examining the performance of 13 European countries' banks, Staikouras and Wood (2003) found that banks could be relatively more profitable with greater levels of equity. Capital strength has been found to be the main determinant of profitability measured by ROA in the sample of 15 EU countries' commercial domestic and foreign banks for period 1995-2001 (Pasiouras & Kosmidou, 2007). Regarding Malaysian banks profitability and for the period 1999-2007, Sufian and Habibullah (2010) found that banks capital ratio has significantly positive relation with their profitability Dawood (2014) examined the impact of capital adequacy (measured by total equity/total assets) on the profitability (ROA) of 23 commercial banks in Pakistan for the period 2009-2012. He found that the capital adequacy has significant positive impact on ROA. Berger (1995) concluded that ROE of US banks has been positively affected by capital adequacy ratio in 1983-1989 and negatively in 1989-1992. Berger explained his results by that the association of capital adequacy ratio with profitability has been affected by the specific circumstances at the examining time. He argued that when banks financial situation is perceived as risky, capital adequacy ratio will positively affect profitability and in normal situations, it will negatively affect profitability due to alternative capital cost. The main problem rose regarding this result is how to limit the optimal level for the capital adequacy ratio.

Analysis of findings

Overview

The asset composition of these three (3) commercial banks asset base aggregate to 71 Percent of the total commercial bank's assets in Guyana. The years examined are from 2010 to 2017 and the primary area examined is Earnings and Profitability. These commercial banks are;

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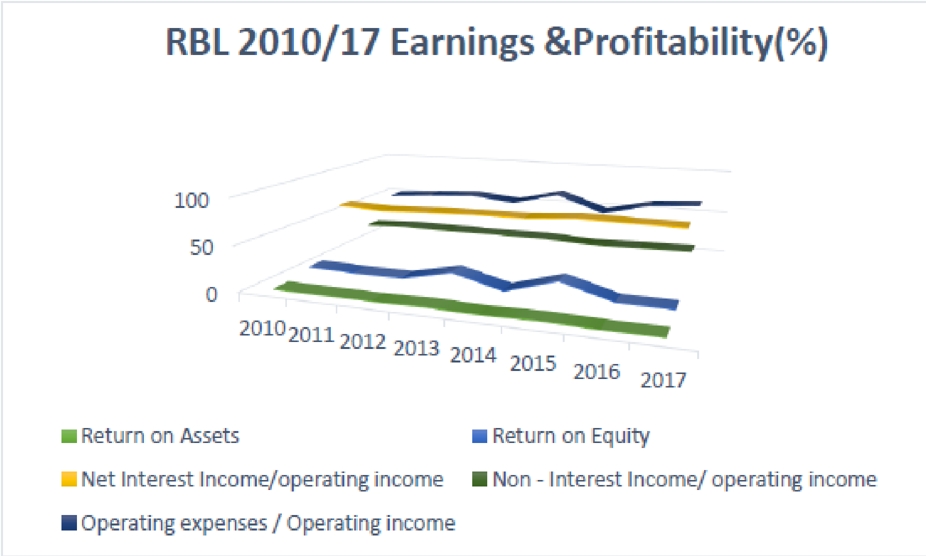
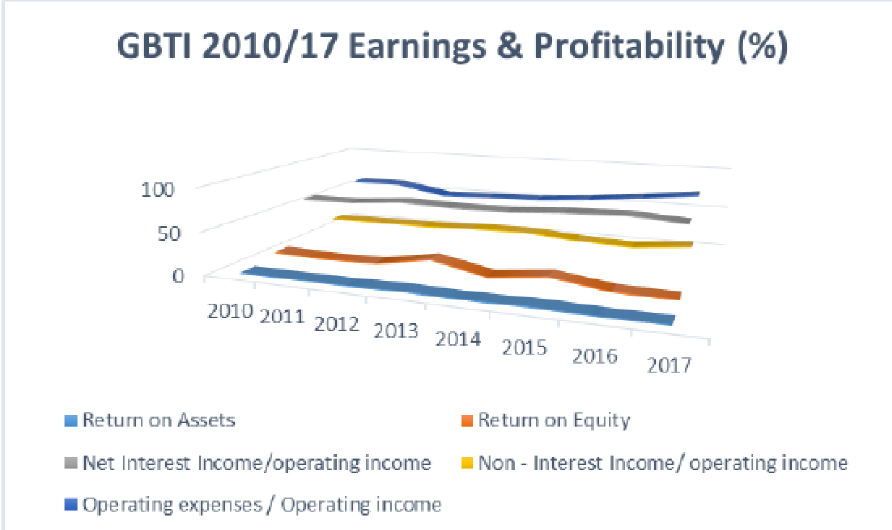
1. Republic Bank Guyana Limited (RBL) Asset; GYD 158 Billion dollars.
2. Guyana Bank for Trade and Industry Limited (GBTI) Asset; GYD 100 Billion dollars.
3. The Bank of Nova Scotia (BNS). Asset; GYD 73 Billion dollars.

Table 1.



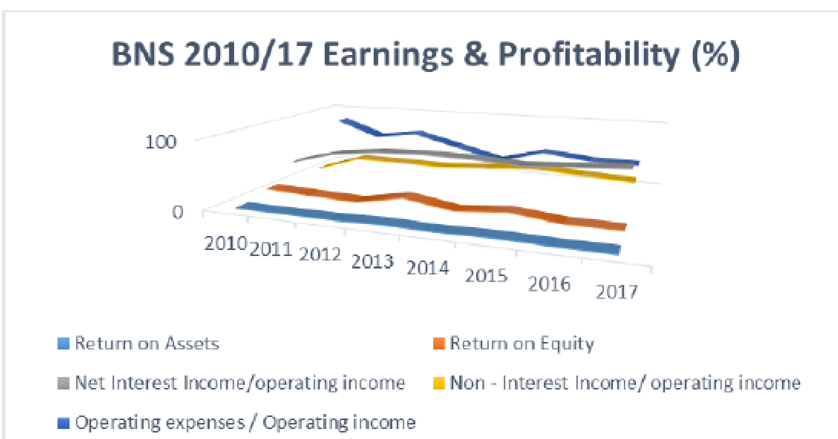
RBL's ROA was relatively stable around 0.40-0.50% benchmarked within years 2010-2014. In year 2015 the bank recorded its highest level at 1.71%. However, for years 2016 and 2017 trends decline. This is an indication that the bank is not making sufficient returns from its asset's investments. This decline can be correlated to a number of factors such as relatively fixed expense, competitive interest rate pressures, shrieking revenue margins, etc. On the other hand, its ROE was exceptional in year 2015 at 19.75% and decline significantly over the last two years 2016 and 2017. The bank net interest income / operating income has an average of 66% with again 2015 been the better year for the bank. This can be viewed that the bank is striving to achieve continuous interest income and with over 66% on its income generated from lending activities. Further, to discussion its other income has be averaging at 25.79%. This highlights that the bank is making a quarter of its income from FX revenues, fees, commission etc. and these types of revenues do provide leverage to the bank's overall profitability line. One must be caution that exceptional level of fee or charges may be a deterrent of doing business with an entity. The banks operating expenses to operating income has increase from 51.04% in 2010 to 64.84 % at the end of 2017. This can suggest that the bank has a high level of operating expenses such as the maintenance of buildings, staff cost and administrative expenses. Notably having operating expenses at 64.84% of dollar earned is not a preferably leverage but rather one which now requires prudent expense margin in the light of declining revenue margins.

Table 2.



The Guyana Bank for Trade and Industry Limited (GBTI) ROA has been fluctuating over the years 2010 to 2017 with its highest level recorded in 2013 at 1.76% and lowest in 2017 at 0.40%. Further notably the banks ROA is having declined year over years between years 2015 to 2017 and this trend is an indicator that the banks' revenue line is shrieking Hence, its ROE is also reflecting similar trajectories with its ROE moving from year 2015 from 12.53% to 2.62 % at the end of 2017. Further, the bank's net interest income to operating income has been stable with an average of 64.74%. This can be attributed to increase in advances and loans portfolio coupled with a decent average interest rate spread against their marginal cost of funds which contributed to the increase interest earnings from 2013 to 2017. Additionally, the bank's non-interest income has been steadily increasing from 2010 to 2014 until fall offs in 2015 and 2016. However, in 2017 the percentage earned on non-interest revenue moved favorable from 18.94% in 2015 to 23.09% in 2017. It suggests that the bank is maintaining high levels of service charges/ commission and on the other hand striving to rebound in market share on the FX trading market. On expense management inclusive of its non-performing portfolio provisioning, the banks expenses are continuously increasing from 48.93 % in 2012 to 71.77% in 2017. This is not a favorable trend for assets quality and revenue line and doesn't auger well for long term sustainability of the bank. In fact, when measured separately the banks revenue line is decline whilst it's operating expenses is growing at a faster rate that its income.

Table 3.



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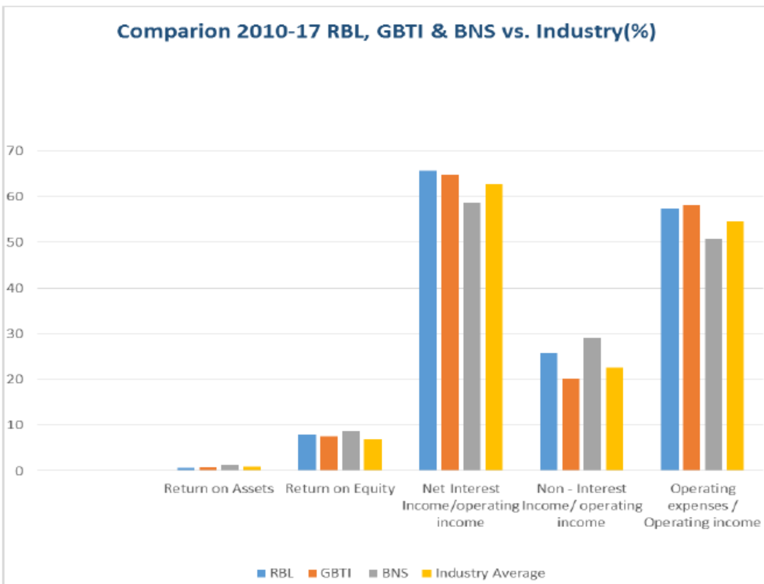
The Bank of Nova Scotia has been achieving a consistent level of return of its assets. Its average over the last eight years 2010-2017 has been recorded at 1.31%. This is also reflective in the banks ROE which has been averaging around 8.62% over these last eight years. For the bank its highest level of ROA was recorded in 2013 and 2015 at 2.46% whilst its highest level of ROE was recorded in 2013 (17.69%) and 2015 (12.84%). Most recently in 2017 both its ROA and ROE has been on the decline, a trend that can be associated as systematic to the Guyana's banking industry. BNS Guyana interest income has been increasing over the years which is an indication that focus is on asset growth. Also, its non-interest income has increased from 8.26% in 2010 to an average of 29.11% over the last eight years. As mentioned previously this can be attributed to increasing market share an earnings of FX market coupled with fees and commissions earned from different services offered. Also, the bank is seeking to structurally manage its operating expenses as evident a reduction from 79.92% in 2010 to 39.27% in 2017 when compared to its operating income. Also, to note the Bank of Nova Scotia has the least number of branches as compared to as compared to RBL and GBTI. RBL has an estimated 11 branches, GBTI 13 and BNS 5. This can impact expense and revenue lines.

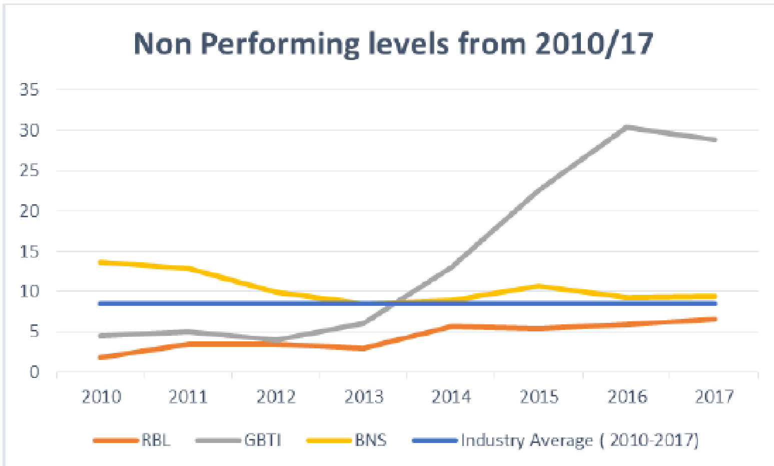
Industry average

Table 4.



The Bank of Nova Scotia has the highest level at 1.31% when compared to industry average at 0.97% followed by GBTI (0.84%) and RBL (0.69%). On the other hand, BNS also has the highest level in ROE at 8.62% when compared to an industry average of 6.96%. GBTI at 7.55% and RBL at 7.93%. RBL has the highest level of income from its interest earnings (65.64%) against a market average of 62.75% followed with GBTI (64.74%) and BNS Guyana (58.65%). This is largely appropriated to each banks level of advances and loans portfolio. RBL has loan portfolio 58% larger than GBTI and 116% larger than BNS Guyana. Hence the revenue earned on interest income should assumedly be higher. Further, BNS Guyana is ranking the highest on non-interest income at 29.11 % when compared to market average at 22.69% followed with RBL (25.79%) and GBTI (20.29%). This can be attributed to higher FX market share and revenues. On the operating expenses to operating income BNS Guyana ranks fairly well at 50.75% when compared to market average of 54.57%, followed with RBL (57.34%) and GBTI (58.08%). This trickles down to prudent operational and expense management. BNS Guyana is yielding results from a positive trend of migrating customers to digital channels and platforms, hence managing operational cost and risk and reducing the need for structural branches networks. Further, RBL and GBTI has the most branch network in the country and hence this may be an operation cost burden especially where profit margins are becoming thin. Another contributing factor to the GBTI profitability weakens as a result on the back of increase NPLs. (See chart (5) below on increase trends from 5% in 2010 to 30 % in 2016).

Table 5.



Conclusion

In recent decades, the banks have undergone extensive transformations brought about by the evolution of the contemporary economy, the behavior of recipients of banking services, the policies pursued by Governments over the banking sector and the progress of modern technology. Bank profits are essential purpose of the establishment and operation of a bank. Appears as the difference between revenues and expenses.

Commercial banks in Guyana particularly RBL and GBTI have to strengthen their oversight and management of structural cost associated within their business line more so especially when there is no real credit growth within the Guyanese banking sector coupled with high levels of increased delinquency and restrictions by regulators on foreign exchange spreads. Hence in the absence of real credit growth banks are competing for current customers by offering the best interest rate, products and service. This can further compress one's revenue line. Therefore, the primary strategy would be to maintain sustainable levels of revenue and prudently manage expenses in line with business activity requirements. The way forward will be digital transformation which can provide fix to structural issues (Possibility of reduction in staffing/ branches). More so a narrow focus on core adjacencies ignores the broader role a bank can play on behalf of its customers. By moving into ecosystems beyond the traditional core, banks are able to tap their existing client base and operational capabilities, strengthen engagement, and capture data that will provide a more complete view of customers' needs. For example: Idea bank and ING, have extended into banking adjacencies by providing services like accounts-receivable management, factoring, accounting, and cash-flow analysis to small and medium enterprise (SME) customers. The fintech start-up Moven built a pioneering mobile money-management app and is now partnering with financial institutions to provide this service to retail customers.

According to the American Banker research banking is transforming by adaptation to artificial intelligence and machine learning, artificial intelligence and open banking concept, Cybersecurity and biometrics and commercial banking innovation. This requires capital expenditure at initial stages but over the long run however benefits can compensate. BNS Guyana may be at an advantage of been an international bank and can lean on support from its head office whereas the local banks in Guyana will have to source funding. Again, they can providing that they plan for these types of capital expenses and manage cuts in other areas to support capital cost. Further most of the banking sector transactions will be

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migrating to an electronic funds transfer system and an e clearings system. A more incentive for RBL and GBTI to commence the introductory thought process to digital transformation bank. Simple put; its best practices on lean management and leading with inner agility.

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