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Financial Performance of the Ethiopian Banking Sector

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Abstract: ***This study investigates the financial performance of the Ethiopian Banking sector using the panel data set for the period 2004/05 – 2009/10. The financial performance of the Ethiopian Banks has been evaluated using the volume of deposit, bank assets, ROE, ROA, and loan-deposit ratio /LDR/. Therefore, a sample of seven commercial banks were selected using simple random sampling technique. The result of the study indicates the Ethiopian banking sector in general, as measured by volume of deposits, granting of loan and possession of assets has also shown a persistent increase throughout the study periods. Moreover, the profitability of the banks during the study periods in particular, and the sector in general presented a tremendous improvement.***

Keywords: Ethiopian Banks, Financial Performance, Profitability

1. Introduction

The role of an efficient banking system in 3economic growth and development lies in savings mobilization and intermediation. Banks, as financial intermediaries, channel funds from surplus economic units to deficit units to facilitate trade and capital formation among others. As Ncube and Senbet 1994 cited in Chirwa 2001) argue, an efficient financial system is critical not only for domestic capital mobilization but also as a vehicle for gaining competitive advantage in the global markets for capital. For the financial system to be efficient, it must pay depositors favorable rates of interest and should charge borrowers favorable rates of interest on loans. The financial intermediation activity in banking involves screening borrowers and monitoring their activities, and these enhance efficiency of resource use. The authors also argue that small investors (depositors) who face costly contracting and asymmetric and imperfect information appoint large financial institutions as delegated monitors in the intermediation process. These financial institutions receive large amounts of information from borrowers on which they base the decision to extend a line of credit to industry.

In Ethiopia the financial sector remains closed and is much less developed compared with sub-Saharan countries. Ethiopia has no capital market and very limited informal investing in shares of private companies. A series of financial sector reforms has been introduced since 1994, when private banks were allowed to be re-established. Besides, structural reforms focusing on lifting most domestic price controls, reducing import tariffs, and moving to a market-based system of foreign exchange allocation.

Therefore, this study analyzes the financial performance of the Ethiopian Banking sector through profitability and liquidity measurement criteria focusing on selected banks operating in Ethiopia.

2. Literature Review

The banking business was the first financial business started in Ethiopia after two decades following the establishment of the capital city, Addis Ababa, in 1886. The first bank in Ethiopia was Bank of Abyssinia. This bank was liquidated and replaced by Bank of Ethiopia in 1931 with the aim of reorganizing the banking and currency of the country under national auspices (Solomon, 2011).

As the development of the banking business is progressing, the country established the State Bank of Ethiopia, which went operational on the 15th of April 1943 having a status of central and principal commercial bank with powers to issue bank notes and coins as agent of the then Ministry of Finance and to engage in all commercial banking activities, Solomon (Ibid). However, the new banking proclamation issued in 1963 splits the functions of the State Bank of Ethiopia into central and commercial banking as the National Bank of Ethiopia and the Commercial Bank of Ethiopia respectively. Both were government-owned. The banking law also allowed the formation of private domestic banks and the entry of foreign banks through joint ventures with maximum foreign ownership of forty nine percent (Alemayehu, 2006 and Solomon, 2011).

From the year 1974 onwards the growth of the banking businesses in Ethiopia came down due to the coming into power of the Provisional Military Administrative Council (PMAC) which adopted socialism as the guiding ideology. Accordingly, during the early ages of the socialist government, some major economic measures have been taken such as to nationalization of all private banks.

After two decades, the country owing to the financial sector reform made based on the economic policy (market oriented) change as a result of government change in 1991. Following the change of government, Ethiopia re-opened its doors to private investors (limiting to Ethiopian nationals) to participate in the financial sector. Also, like many least developed countries (LDCs), Ethiopia has also been engaged in structuring and restructuring of its various institutions since 1992 which includes lifting most domestic price controls, reducing import tariffs, and moving to a market-based system of foreign exchange allocation (Alemayehu 2006).

Though the march to market-oriented economic system was started in Ethiopia during the early 90s, some changes and growth have been observed in the banking sector. This can be witnessed by continued increases in number, capital base, assets possession, service expansion, branch networks… etc.. Despite the existence of these hard evidences the Ethiopian banking sector is still less developed compared with other Sub-Saharan countries (NBE, Annual Reports).

The banking sector in Ethiopia has not been studies to any great extent. However, a study made by Gardachew explains that there is statistically significant difference on the public banks average performances of demand deposits, saving deposits, total deposits, loans and advance and outstanding credits between the pre and post financial reform periods. He concluded that financial liberalization has brought significant change on performance of public banks.

This summary of research findings made in the nation identified that the overall performances of the Ethiopian banks were good enough and they provided the possible reasons for it. One way or the other, this study may be perceived as a continuation of them being focusing on the very recent years of performance of the Ethiopian banking sector.

3. Objectives of the Study

The main objectives of this study are;

- to evaluate the impact of the major financial liberalization measures taken by the government of Ethiopia on the financial performance of the commercial banks.
- to identify areas that need further liberalization or financial reform measures so as to enhance the performance of the banking sector

4. Methodology

1) Sample

The sample used in this study consisted of seven commercial banks except one all started their operation after the new financial reform (see the introduction above). These commercial banks are selected based on the fact that they are the top senior commercial banks, by age of establishment.

2) Variables

Financial management theories provide various indexes for measuring a bank's performance. One of them is accounting ratios, the use of which is quite common in literatures. This study, therefore, will use the following ratios/variables/ to measurement the commercial banks performance.

Profitability Measures

a) ROE = Net Profit After Tax / Shareholders Equity
Or
b) ROE = Net Profit Margin x Asset Utilization Ratio x Equity Multiplier, where

- $Net\ Profit\ Margin = \frac{Net\ Income\ After\ Tax}{Total\ Operating\ Income}$
- $Asset\ Utilization = \frac{Total\ Operating\ Revenue}{Total\ Assets}$
- $Equity\ Multiplier = \frac{Total\ Assets}{Total\ Equity}$

c) ROA = Net Profit After Tax / Total Assets

Liquidity Measures

a) Loan Deposit Ratio = Loans and Advances/ Total Deposits

1) Data Source

- The study used purely secondary data source which include annual reports and audited financial statements of the banks, proclamations, directives and provisions issued by the NBE , various magazines, journal articles, proceedings and publication including web sites of different organizations were referred.

2) Data Analysis

- The method of data analysis is both descriptive and analytical. For this purpose, graphs and tables are used by the help of spreadsheet (MS Excel). To identify the relationship among the variables, correlation analysis technique was introduced.

5. Empirical Findings

This part will present the empirical findings that describe the impact of the financial liberalization on the performance of the banking sector of Ethiopia. The data for the survey was collected from the annual reports of the individual banks and also the Central Bank of Ethiopia quarterly and annual reports from 2004/05 to 2009/10 fiscal years. A total of 105 audited annual financial statements of the selected seven banks and 9 years quarterly and annual reports of the Central Bank of Ethiopia were used as major data sources. The banks included in the sample are Commercial bank of Ethiopia /CBE/, Construction and Business Bank /CBB/, Dashen Bank/DB/, Bank of Abyssinia/BOA/, Wegagen Bank/WB/, United Bank/UB/, and Nib International Bank /NIB/.

The study took an in depth evaluation of the performances of the commercial banks based on the selected financial ratios among others.

The way the performance evaluation of the Ethiopian banks begins from measuring the total value of the assets possessed and the volume of deposits. As it is indicated in table 1 below, the total assets of the banks showed a continuous growth at an average yearly growth rate of 19.73% during the study periods /from 2004/05 to 2009/10.

Table 1: Asset possession of the banks (in Millions of Ethiopian Birr)

Year	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Total Assets	45,075	50,442	61,578	73,101	89,969	110,589

* The total figure refers only the sample banks
Source: Computed from the annual reports of the banks

As can be seen from the above table (table 1), there is a continuous growth in total assets of the banks. There are varieties of reasons among others the expansion of branches by these banks is dominant one. The next criterion, for the assessment of the performance of the Ethiopian banks, is the volume of the total deposits the banks received from their customers during the study period. See figure 1 below

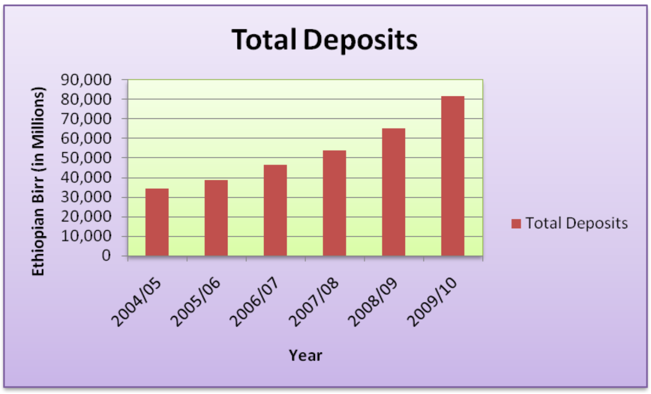

Figure 1: Total Deposits of the Banks

Like that of the assets of the banks, the total deposits of these banks showed a continuous increase at an increasing rate yearly and registered an average rate of increase of increase of 19% during the study periods. The total deposits of the banks include the three main types of deposits, viz; demand deposits, saving deposits, and time deposits. Hence, it will be more interesting to see which types of deposit holds the lion's share from these total figures of deposits kept by the Ethiopian banks.

Table 2: The Demand, Savings, and Time deposits of the Ethiopia Banks (in Millions of Ethiopian Birr)

Year	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Demand Deposits	18,919	21,192	26,034	30,092	38,091	46,457
Savings Deposit	17,311	20,464	23,576	29,115	36,462	45,827
Time Deposits	2,285	2,803	4,255	3,749	4,949	6,349
Total	**38,515**	**44,459**	**53,865**	**62,956**	**79,502**	**98,633**

Source: Annual reports of the banks

As it is evidenced from the table 3 above, the demand deposits and savings deposits shared almost equal amount of the total deposits though out the study periods. Both registered a share of 47.95% and 45.56% on average from the total deposits during the study periods leaving the remaining share to the time deposits. During the study period, demand deposits and savings deposits continuously increased at an annual average rate of increment of 20% and 21.6% respectively. Also there was a continuous increase in time deposits at a higher annual average rate of increase of 24.4%. It would be more interesting if the total deposit mobilization of the banks is compared with the total GDP of the country during the study periods as it is presented in table 3 and the related figure 2 below.

Table 4: Total Assets and Bank Deposits versus GDP

Year	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Total Assets	45,075	50,442	61,578	73,101	89,969	110,589
Total Deposits by the banks	34,280	38,888	46,705	53,874	65,286	81,914
Country's GDP	106,473	131,642	171,990	248,606	336,106	383,364
Total Assets as of %GDP	42%	38%	36%	29%	27%	29%
Total Deposits of the banks as of % of GDP	32%	30%	27%	22%	19%	22%

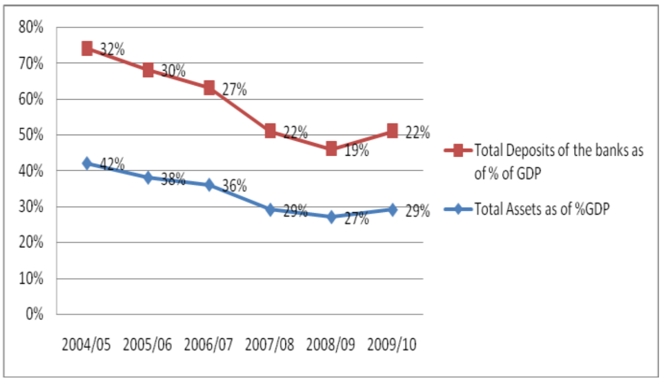

Figure 2: Total Assets and Deposits of the banks as percentatge of GDP

Source: Compiled from annual reports of the Central Bank of Ethiopia and the individual banks

Very surprisingly, the contribution of the banks to the country's GDP, based on the total assets possessed and the deposit mobilized by the banks, shows a continuous sharp decreases. This implies the rate of increase in GDP was by far very large than the rate of increases registered by the banks' assets and deposits. The average rate of increase in GDP registered during the study periods was 28%. The next part of the analysis will concentrate on the profitability of the banks using ROA and ROE as its measures.

ROE and ROA are the indicators of measuring efficiency. ROE is net earnings per dollar amount equity capital. The higher ratio is an indicator of higher managerial performance. Similarly, ROA is net earnings per unit of a given asset. It shows how a bank can convert its asset in to net earnings. The higher ratio indicates higher ability and therefore is an indicator of better performance (see table 4).

Table 4: ROE and ROA in percent during the study period

Year	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Average ROA	1.68%	2.09%	1.63%	1.98%	1.95%	1.91%
Average ROE	20.42%	24.41%	14.06%	17.66%	19.11%	19.61%

Source: Computed from annual reports of the central bank and the individual banks

Though both ROA and ROE showed progress in their own figure, the value of ROE is better than ROA. However, the return on assets in absolute figures is smaller. One of the several reasons for this small return is much of the assets section of the balance sheet of the banks is possessed by the liquid cash or the cash on hand, in most of the banks it consists above 30% of their total assets. Since holding large amount of cash on hand will not result any benefit, the return of assets of the Ethiopian banks is very poor. This is due to the banks' excess liquidity position. With regard to ROE, relatively the figures are so high during the study periods. This implies the owners are getting much return for their investment with a super rate of return exceptionally in 2005/06 which was not repeated in the subsequent years. However, the general conclusion is that even if ROE is positive in all the study periods, the rate of increasing is in a decreasing trend. Taking the other part of the total equity i.e. liabilities of the banks, into account the following table (Table 5) makes a comparison on the growth trend in the total shareholders' equity and in the total liabilities of the banks during the study period.

Table 5: Total Debt Vs Total Shareholders' Equity

	2004/05	*2005/06*	*2006/07*	*2007/08*	*2008/09*	*2009/10*
Total Debt (in Million Birr)	42,622	47,519	55,507	66,199	79,489	98,844
Total Shareholders' Equity (in Million Birr)	2,560	3,079	6,283	7,161	8,185	9,331
Change in Debt (in %)		11.49%	16.81%	19.26%	20.08%	24.35%
Change in Equity (in %)		20.29%	104.06%	13.98%	14.30%	14.01%
Debt-to-Equity	17x	15x	9x	9x	10x	11x

Source: Computed from annual reports of the Banks

These banks, as deposit taking institutions, are heavily concentrated their debt by customers' deposits. This makes them to be extremely highly leveraged businesses that finance above 88% of their assets by debts of customers. The strength of the debts can be witnessed from the above table in that their rate of change is after half of the study period is far larger than the rate of change in shareholders' equity in the same time period. Moreover, it is still visible to observe how the debt balance in the balance sheets of the banks is financing the equity of the banks.

The third and the final part of our analysis will concentrate on the liquidity of the banks using LDR as its measure. One of the most important tasks faced by the management of any bank is ensuring adequate liquidity. A bank is considered to be liquid if it has ready access to immediately spendable funds at reasonable cost at precisely the time those funds are needed. Otherwise, when a mismatch arises between the maturity structure of a bank's assets and liabilities, it is called a liquidity risk. Therefore, a bank must always know and measure its liquidity status.

As a measure of liquidity ratio, a higher LDR indicates that a bank takes more financial stress by making excessive loan. Therefore, lower loan deposit ratio is always favorable to higher loan deposit ratio.

Table 6: Loan Deposit Ratio of the banks

Year	2009/10	2008/09	2007/08	2006/07	2005/06	2004/05
Average LDR	57.29%	62.85%	72.85%	76.22%	79.60%	68.25%

Source: Computed from annual reports of the Banks.

Even if some fluctuations are observed during the period of the study, the LDR indicates in the Ethiopian banks there is a financial stress. The very reasons for this could be the huge amount of deposits the banks retain from their customers and the stringent loan granting criteria. This does mean the banks are still poor in making investments by granting loans. This one way or the other tells us there is less practice of risk taking and inadequate risk management system. Hence, such a practice must be redirected in order to enhance investment and prosperity in the banking sector in general.

6. Conclusion

In Ethiopia, reformation in the financial system that has been taken in the mid-1990s and currently also going on under varieties of forms brought several promising changes in the overall performance of the financial sector and in particular to the banking sector. The macro prudential regulations released by the regulatory body, the National Bank of Ethiopia (Central Bank), are conducive enough in doing business in the banking sector. This can be evidenced from the number of banks and their branch network rapid expansion. For instance, at the end of 2009/10 fiscal year there were 12 private banks and 3 state owned banks, with total branches of 681 throughout the country in 15 years' time. The asset possession and the deposit mobilization by the banks is showing continuous improvement and all banks had the benefit of profit year after year. The new culture of competing with the state owned banks is also witnessed in private banks. However, we also recommend the concerned regulatory body to think of on the heavy and very large excess liquidity of the banks, by providing varieties of investment opportunities, as currently started government bonds. Besides, the liberalization process must train the banks to be ready to face competition with foreign banks than always giving a shadow to them by protecting the entrance of foreign banks. For this, the regulatory body must work with the endogenous banks and encourage them to start varieties of other new financial products and advance their skill of taking and managing risk.

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