INTERNATIONAL JOURNAL OF SOCIAL Sciences and Information Technology
ISSN 2412-0294 www.ijssit.com

http://www.ijssit.com

FACTORS AFFECTING FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN GAROWE, SOMALIA

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Abstract

The common assumption, which underpins much of the financial performance research and discussions, is that increasing financial performance will lead to improved functions and activities of the organization. Financial performance analysis of commercial banks has been of great interest to academic research since the Great Depression Intern the 1940's. In the last two decades studies have shown that commercial banks in Sub-Saharan Africa (SSA) are more profitable than the rest of the world with an average Return on Assets (ROA) of 2 %. This study was focused on the factors affecting the financial performance of Commercial Banks in Garowe, Somalia while guided by the following objectives; To evaluate how inflation rates influence the financial performance of commercial banks in Garowe; To examine how interest rates influence the financial performance of commercial banks in Garowe; To establish how credit risk exposure influences the financial performance of commercial banks in Garowe; To assess how technology influences the financial performance of commercial banks in Garowe. The researcher used descriptive research design and study targeted a total of 178 respondents including commercial banks managers and others employees on commercial banks. From the findings of the study, a model summary of the regression analysis shows that Credit Risk, Inflation, interest rate and technology accounted for 72.4 % of the variance in the financial performance of commercial banks operating in Garowe (R square = 0.724). This shows that 27.6% of the variance in growth was explained by factors not in the study. The study results discovered that stability in inflation rates helps in regulating both foreign exchange rates and interest rates. The study results also revealed that credit risk exposure affects banks profitability. That secured loans through collateral are less likely to default as compared to unsecured loans.

***Keywords**: Inflation rate, credit risk, financial performance, commercial banks*

1. Background to the Study

Bank is very old institution that is contributing toward the development of any economy and it's treated as an important service industry in modern world. Nowadays the function of bank is not limited to with the same geographical limit of any country. It is an important source of financing for most businesses. The common assumption, which underpins much of the financial performance research and discussions, is that increasing financial performance will lead to improved functions and activities of the organization (Liargovas et al., 2008). The financial performance of companies are globally as subject that have attracted a lot of attention, comments and interests from both financial experts, researchers, the generally including public and the private management of banks entities. The Financial performance of a firm can be analyzed in terms of profitability, dividend growth, sales turnover, and return on investments among others. However, there is still debate among several disciplines regarding how the performance of firms should be measured and the factors that affect financial performance of companies (Liargovas et al., 2008).

Thus, financial performance analysis of commercial banks has been of great interest to academic research since the Great Depression Intern the 1940's. In the last two decades studies have shown that commercial banks in Sub-Saharan Africa (SSA) are more profitable than the rest of the world with an average Return on Assets (ROA) of 2 percent (Flamini et al., 2009). One of the major reasons behind high return in the region was investment in risky ventures. The other possible reason for the high profitability in commercial banking business in SSA is the existence of huge gap between the demand for bank service and the supply thereof. That means, in SSA the number of banks are few compared to the demand for the services; as a result there is less competition and banks charge high interest rates. This is especially true in East Africa where the few government owned banks take the lion's share of the market. The performance of commercial banks can be affected by internal and external factors (Al-Tamimi, 2010; Aburime, 2005). These factors can be classified into bank specific (internal) and macroeconomic variables. The internal factors are individual bank characteristics which affect the bank's performance. These factors are basically influenced by the internal decisions of management and board. The external factors are sector wide or country wide factors which are beyond the control of the company and affect the profitability of banks. (Vincent and BerhanuKusa 2013).

Structural Adjustment Programs (SAP) in the late 1980's, the banking sector worldwide has experienced major transformations in its operating environment. Countries have eased controls on interest rates, reduced government involvement and opened their doors to international banks (Ismi, 2004). Due to this reform, firms of the developed nations have become more visible in developing countries through their subsidiaries and branches or by acquisition of foreign firms. More specifically, foreign banks' presence in other countries across the globe has been increasing tremendously. Since 1980's, many foreign banks have established their branches or subsidiaries in different parts of the world. In the last two decades or so, the number of foreign banks in Africa in general and Sub-Saharan Africa in particular has been increasing significantly. On the contrary, the number of domestic banks declined (Claessens and Hore, 2012.) These have attracted the interests of researchers to examine bank performance in relation to these reforms. There has been noticed a significant change in the financial configuration of countries in general and its effect on the profitability of commercial banks in particular. It is obvious that a sound and profitable banking sector is able to withstand negative shocks and contribute to the stability of the financial system (Athanasoglou et al., 2005.) Moreover, commercial banks play a significant role in the economic growth of countries. Through their intermediation function banks play a vital role in the efficient allocation of resources of countries by mobilizing resources for productive activities. They transfer funds from those who don't have productive use of it to those with productive venture. In addition to resource allocation good bank performance rewards the shareholders with sufficient return for their investment. When there is return there shall be an investment which, in turn, brings about economic growth. On the other hand, poor banking performance has a negative repercussion on the economic growth and development. Poor performance can lead to runs, failures and crises. Banking crisis could entail financial crisis which in turn brings the economic meltdown as happened in USA in 2007 (Marshall, 2009.) That is why governments regulate the banking sector through their central banks to foster a sound and healthy banking system which avoid banking crisis and protect the depositors and the economy (Heffernan, 1996; Shekhar and Shekhar, 2007.) Thus, to avoid the crisis due attention was given to banking performance.

A more organized study of bank performance started in the late 1980's (Olweny and Shipho, 2011) with the application of Market Power (MP) and Efficiency Structure (ES) theories (Athanasoglou et al., 2005.) The MP theory states that increased external market forces results into profit. Moreover, the hypothesis suggest that only firms with large market share and well differentiated portfolio (product) can win their competitors and earn monopolistic profit. On the other hand, the ES theory suggests that enhanced managerial and scale

ISSN 2412-0294
Vol V Issue V, May 2019

efficiency leads to higher concentration and then to higher profitability. According to Nzongang and Atemnkeng in Olweny and Shipho (2011) balanced portfolio theory also added additional dimension into the study of bank performance. It states that the portfolio composition of the bank, its profit and the return to the shareholders is the result of the decisions made by the management and the overall policy decisions. From the above theories, it is possible to conclude that bank performance is influenced by both internal and external factors. According to Athanasoglou et al., (2005) the internal factors include bank size, capital, management efficiency and risk management capacity. The same scholars contend that the major external factors that influence bank performance are macroeconomic variables such as interest rate, inflation, economic growth and other factors like ownership.

2. Statement of the Problem

Understanding the factors that influence the performance of commercial banks is critical not only to the management of these commercial banks but also to other stakeholders and interest groups such as the country's Central Bank, the government as a whole, the banker's association as well as other financial authorities in the country (Ayele, 2012).

A search for literature in this area shows that there are various studies that have been carried out both on the international arena, in the African context as well as locally. Obamuyi (2013) evaluated the determinants of a bank's profitability in a developing economy and focused on the banking industry in Nigeria. The study found that bank specific factors such as efficient management of expenses and increased interest income and macro environment factors such as favorable economic conditions lead to improved profitability of commercial banks.

Ongore & Kusa (2013) studied the effects of various factors in banking sector performance in Kenya. The results of the study showed that board and management decisions influence the performance of commercial banks in Kenya and also that macro-economic factors have insignificant influence on their performance. This study however omitted the effects of industry specific factors on the performance of commercial banks. Literature has not specifically focused on the identifying the specific factors that influence bank performance in developing countries but the available literature shows determinants in all economies (Karasulu, 2001). Macro- economic factors that influence the performance of commercial banks have also not been evaluated in the Somalia context despite their importance in determining the performance of any industry in the economy. It is clear therefore that in Somalia, no study has been done on the determinants of bank performance using the industry specific factors, the bank specific factors and the macro-economic factors. This study will focus on the factors affecting the financial performance of Commercial Banks in Garowe, Somalia.

3. Objectives of the study

The specific objectives of the study were:

1. To evaluate how inflation rates influence the financial performance of commercial banks in Garowe.
2. To examine how interest rates influence the financial performance of commercial banks in Garowe.
3. To establish how credit risk exposure influences the financial performance of commercial banks in Garowe.
4. To assess how technology influences the financial performance of commercial banks in Garowe.

4. Geographical scope

The study was conducted in Garowe, Puntland State of Somalia. The area covers the town. These areas will be the geographical limit of the scope of our study, as they are reachable by the researcher.

5. Significance of the study

The study may yield data and information that may be useful for proper management and decision making for commercial banks of Garowe, Puntland.

The findings and recommendations of the study should also be useful to government officials

This study will also useful to the policy makers of puntland state of Somalia towards the improvement of banking system of the country. The study will also add to the existing stock of knowledge in Puntland. It can provide reliable data to the concerned statistics bodies.

The study will also be very useful to the international agencies; where by international investors can rely on the conclusions drawn from the study to carry out certain projects in Puntland.

6. Literature Review

This study was guided by the following theories;

***Pure Expectations Theory*:** According to this theory, a rising term structure of rates means the market is expecting short-term rates to increase. So if the two-year rate is higher than the one-year rate, rates should rise. If the curve is flat, the market is expecting that short-term rates will remain low or hold constant in the future. A declining rate-term structure indicates the market believes that rates will continue to decline. The theory states that, the expected return from holding a long term money or capital market investment until maturity is equal to the expected return from rolling over a series of short term investment with a total maturity equivalent to that of the long term investment (Kim & Orphanides, 2007).

***The Portfolio Theory*:** The portfolio theory approach is the most relevant and plays an important role in bank performance studies (Nzongang and Atemnkeng, 2006). According to the Portfolio balance model of asset diversification, the optimum holding of each asset in a wealth holder's portfolio is a function of policy decisions determined by a number of factors such as the vector of rates of return on all assets held in the portfolio, a vector of risks associated with the ownership of each financial assets and the size of the portfolio. It implies portfolio diversification and the desired portfolio composition of commercial banks are results of decisions taken by the bank management.

Liquidity Preference Theory: This is a variant of the Pure Expectations Theory. It basically adds a premium to the PET-calculated yield for long-term debt to account for investor preference for short-term bonds over long-term ones. This premium is called the term premium or the liquidity premium. It acknowledges the risks involved in holding long-term debt, which is more likely to experience catastrophic events and price uncertainty than is short-term debt. A second premium is also included in LPT, for default risk, which is more likely when holding a bond for a long period of time, once again due to uncertainty.

7. Methodology

The researcher used descriptive research design. Descriptive study is concerned with finding out who, what, where and how much of a phenomenon, which is the concern of the study. (Sekaran, 2011) observes that the goal of descriptive research is to offer the researcher a profile or describe relevant aspects of the phenomena of interest from the individual, organization, industry or other perspective.

The sample size of the study consisted of 123 respondents including managers and employees of the Banks under study, selected from the 178 members of the target population. This sample size was based on the following criteria.

The Slovene's formula was used to determine the minimum sample size.

Table 1: Respondents of the Study will be determined by using Slovene's Formula

Banks	***Target Population***	***Sample Size***
Salaam Bank	40	28
Dahabashil Bank	40	28
Iftin Bank	40	27
Amal Bank	40	27
Tawakal Bank	40	27
Total	**200**	**133**

Source: Central banks of Somalia

Appendix VII - Sloven's Formula (sample size formula)

n= N/1+N (α2) = 200/1+ 200(0.05)^2 =133

Where, n= sample; N=target population; α=constant variable: equivalent to 0.05, which is the allowed margin of error

The study used a questionnaire for data collection and employed stratified random sampling and purposive random sampling techniques.

8. Research Findings And Discussion

The study first sought to establish the position held by the respondents so as to gain relevance to the questionnaire. The findings indicate that there is high employee retention in commercial banks in Garowe, Puntland. If the researcher tends the position of the respondents the result indicates that the 24.3 % of the respondents are top managers of the banks while 30 % of the respondents are middle managers and 45.5% of the respondents are staff. Therefore the finding shows the majority of the respondents of the commercial banks are staff.

Table 2: Position of the respondent

Positions	*Frequency*	*Percentage*
Top management	30	24.3
Middle Manager	37	30
Staff Only	56	45.5
Total	123	**100.0**

ISSN 2412-0294
Vol V Issue V, May 2019

Description of the study objectives

9. Influence of inflation rates on the financial performance of commercial banks in Garowe

Table 3: Inflation rate on financial performance

Inflation Rate	Mean
Interest rates adjustments in Somalia negatively impacts inflation rates.	3.82
Stability of inflation rates plays a role in the profits we make	3.52
There is a negative relationship between inflation rate and bank financial performance	3.61
Depreciation and appreciation of the Somali currencies is a key determinant of our profitability	4.78

The first objective of the study was to establish the effects of inflation rate on financial performance of commercial banks in Garowe. Respondents were asked set of questions related to the variable and their answers was as follows. The statement that interest rates adjustments in Somalia negatively impacts inflation rates had a mean score of 3.82 The statement that stability of inflation rates plays a role in the profits we make had a mean score of 3.52. The statement that there is a negative relationship between inflation rate and bank financial performance had a mean score of 3.61. The statement that depreciation and appreciation of the Somalia currency is the key determinant of our profitability had a mean score of 4.78. This statement is in agreement with Meggie & Gichinga, (2016) that commercial banks profitability is affected either way by depreciation and or appreciation of the local currency.

10. Influence of Credit Risk on the financial performance of commercial banks in Garowe

Table 4: credit risk on financial performance

Credit Risk	Mean
The level of credit risk by the bank will affect its profitability.	3.93
High collateral reduces credit risk exposure of commercial banks.	4.88
The high level of loan defaulters affects profitability.	1.9
Risk attitudes of various customers determine their ability to repay their loans.	3.89

The second objective of the study was to establish the effects of credit risk on financial performance of commercial banks in Somalia. Respondents were asked to respond to set questions related to credit risk and give their views. The statement that the level of credit risk by the bank will affect its profitability had a mean score of 3.93. The statement that high collateral reduces credit risk exposure of commercial banks had a mean score of 4.88. This statement is in agreement with Murerwa, (2015) that secured loans are more likely to repaid and or recovered as opposed to unsecured loans and therefore collateral is an important component of guaranting commercial banks that incase of defaulting then the secured asset is sold and outstanding loan repaid in full. The statement that the high level of loan defaulters affects profitability had a mean score of 1.9 and the statement that risk attitudes of various customers determine their ability to repay their loans had a mean score of 3.89.

11. Influence of Interest Rate on the financial performance of commercial banks in Garowe

Table 5: Interest rate on financial performance

Interest Rate	Mean
High interest rates limits people to borrow thus affecting profitability	3.89
Interest rate charged to customers are a source of revenue to the bank	4.78
Absence of interest regimes affects profitability	3.72
High interest rates affect Loan repayment by customers.	3.93

The third objective of the study was to establish the effects of interest rate on financial performance of commercial banks in Somalia. Respondents were required to respond to set questions related to interest rate and give their opinions. The statement that high interest rates limits people to borrow thus affecting profitability had a mean score of 3.89. The statement that interest rate charged to customers are a source of revenue to banks had a mean score of 4.78. This statement is in agreement with Meggie&Gichinga, (2016) that interest rates charged by commercial banks on loans advanced to customers is the main source of income to commercial banks in Somalia. The statement that absence of interest regimes affects profitability had a mean score of 3.75. The statement that high interest rate affects loan repayment by customers had a mean score of 3.93. This result is consistent.

12. Influence of Technology on the financial performance of commercial banks in Garowe

Table 6: Technology on financial performance

Technology	Mean
Growth of mobile money loans and mobile banks has directly affected our profits	3.98
Growth of technology has reduced transaction costs of commercial banks.	4.83
Use of technology has provided service proximity to customers of commercial banks.	4.78
Technology has led to efficiency in transaction.	3.94

The fourth objective of the study was to establish the effects of technology on financial performance of commercial banks in Somalia. Respondents were required to respond to set questions related to technology and give their opinions. The statement that growth of mobile money loans and mobile banks has directly affected our profits had a mean score of 3.98. The statement that growth of technology has reduced transaction costs of commercial banks had a mean score of 4.83. The statement that use of technology has provided service proximity to customers of commercial banks had a mean score of 4.78. The statement that technology has led to efficiency in transaction had a mean score of 3.94.

13. Regression Analysis Results

Table 7: Model Summary

Model	R	R Square	Adjusted R Square	Sig
1	.851	.724	.676	.000

A Predictors: (Constant), Credit Risk, Inflation, interest rate and technology

International Journal of Social Sciences and Information Technology
ISSN 2412-0294
Vol V Issue V, May 2019

R-squared is a statistical measure of how close the data are to the fitted regression line. It is also known as the coefficient of determination, or the coefficient of multiple determinations for multiple regressions. 0% indicates that the model explains none of the variability of the response data around its mean. The adjusted R-squared is a modified version of R-squared that has been adjusted for the number of predictors in the model. The adjusted R-squared increases only if the new term improves the model more than would be expected by chance. It decreases when a predictor improves the model by less than expected by chance.

The model summary of the regression analysis in Table 7 shows that Credit Risk, Inflation, interest rate and technology accounted for 72.4 % of the variance in the financial performance of commercial banks operating in Garowe (R square = 0.724). This shows that 27.6% of the variance in growth was explained by factors not in the study.

Table 8: ANOVA

	Sum of Squares	**Df**	**Mean Square**	**F**	**Sig.**
Regression	35.775	4	7.944	14.066	.033
Residual	13.654	118	.494		
Total	49.429	122			

The significance value is .044 which is less that 0.05 thus the model is statistically significant in predicting independent variables (Credit Risk, Inflation, interest rate and technology) this shows that the overall model was significant. The general objective sought to determine the factors affecting financial performance of commercial banks in Garowe Puntland. The Pearson Correlation analysis which determines the strength and direction of the relationships was used. The Pearson correlation coefficient ranges from 0 (if no relationship exists) to 1 (for a perfect relationship). Correlation coefficients (in absolute value) which are ≤ 0.35 are generally considered to represent low or weak correlations, 0.36 to 0.67 moderate correlations, and 0.68 to 1.0 strong or high correlations with r coefficients > 0.90 very high correlations(Field,2005).

Table 9: Pearson's Correlation Analysis

	CRM	**IRM**	**LRM**	**FRM**	**GROWTH**
CREDIT RISK	1				
INFLATION	. 599(**)	1			
INTREST RATE	. 579(**)	.799(**)	1		
TECHNOLOGY	. 111(*)	. 211(**)	.211(**)	1	
PERFORMANCE	. 711(**)	. 531(**)	.611(**)	.535(**)	1

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

The general objective was analyzed using multiple regression analysis. Multiple regression analysis was carried out to establish the extent to which the combined effect of Credit Risk, Inflation, interest rate and

ISSN 2412-0294
Vol V Issue V, May 2019

technology effectthe financial performance of commercial banks in Garowe. Before the regression analysis was carried out, Pearson's correlation analysis was carried out to ensure that there was no multicollinearity. Multicollinearity exists when there is a strong correlation between two or more independent variables and this poses a problem when running multiple regressions. According to Field (2009) multicollinearity exists when correlations between two independent variables are at or in excess of 0.80. In this study, the highest correlation was between market risk management and liquidity risk management (r = 0.799, p < 0.000) which rules out multicollinearity.

The study conducted a multiple regression analysis and from the regression model, holding (Credit Risk, Inflation, interest rate and technology) constant at zero, the growth of the financial institutions will be 1.147. A one percent (1%) change in credit risk will lead to (0.458%) variation in the growth of the financial institution; also a one percent (1%) change in technology will lead to (0.279%) variation in growth of the financial institution.

Further, a (1%) change in inflation will lead to (0.324%) variation in growth of the financial institution and lastly a (1%) change in interest rate will lead to (0.251%) variations in growth of the financial institution. This shows that there is a positive relationship between (credit risk management, market risk management, liquidity risk management and foreign exchange risk management) and growth of the financial institution.

Table 10: coefficients

	Unstandardized Coefficients		**Standardized Coefficients**	**t**	**Sig.**
	B	**Std. Error**	**Beta**		
(Constant)	1.147	3.83		2.915	.000
Credit Risk	.458	.221	.673	1.988	.001
Inflation	.324	.116	.367	2.608	.004
Interest rate	.251	.125	.182	1.817	.002
technology	.279	.145	.377	1.991	.003

The Unstandardized beta coefficients column in Table 10 above were used to obtain the overall equation as suggested in the conceptual framework. When these beta coefficients are substituted in the equation, the model becomes:

$Y = 1.147 + 0.458X1 + 0.324\ X2 + 0.251\ X3 + 0.279X4 + \varepsilon$ where

Y = financial performance, X1 = Credit Risk, X2 = Inflation, X3 = interest rate, and X4 = technology.

The results also show the unique contribution to the explaining of the independent variable. The standardized coefficients assess the contribution of each independent variable towards the prediction of the dependent variable, since they have been converted in the same scale to show Comparison. Table 8 indicates that Credit Risk was the most significant with p-values of 0.001 followed by interest rate with p-values of 0.002 respectively. The t-test statistic shows that all the B coefficients of are significant (since $p<0.05$).

12. Conclusions

Influence of inflation on the financial performance of commercial banks in Garowe Puntland.

The study results discovered that stability in inflation rates helps in regulating both foreign exchange rates and interest rates. When the inflation rate is high, borrowers most often default causing loss of revenue to the commercial banks. When inflation is rising, consumer purchasing power is greatly reduced because many people are not able to borrow and invest and eventually repay loans.

Influence of credit risk on the financial performance of commercial banks in Garowe Puntland.

The study results revealed that credit risk exposure affects banks profitability. That secured loans through collateral are less likely to default as compared to unsecured loans. Thus this helps the commercial banks to conserve its capital thereby reducing losses. The study further revealed that risks attitudes by various customers determine their abilities to repay loans and this affects loans uptake.

With reference to the analysis of this variable indicate that there is a significant predictor to financial performance of commercial banks in relation to the credit risk in Garowe Puntland Somalia. It was observed that credit risk affected the cash flow and the funds available for funding to a great extent. This implies that secured loans through collateral are less likely to default as compared to unsecured loans. Thus this helps the commercial banks to conserve its capital thereby reducing losses. The study further revealed that risks attitudes by various customers determine their abilities to repay loans and this affects loans uptake.

Influence of interest rate on the financial performance of commercial banks in Garowe Puntland.

The findings indicate that high interest rates limits people to borrow thus affects profitability of commercial banks. Interest rates are the most important tool of commercial banks since it forms the bulk of revenue earned by commercial banks. Further the study revealed that when interest rates are high borrowers default on loan repayments.

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