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Bank Competitiveness and Profitability in the Banking Sector: A Review of Literature

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Abstract
The paper sought to carry out a review of literature on bank competitiveness and profitability in the banking sector. This paper was extracted from the author's PhD thesis. Theoretically, different prepositions have been provided to underpin bank competitiveness and profitability nexus. In view of market power hypothesis, banking industries with higher levels of concentration are characterized by increasing profitability which is influenced by the underlying benefits of having greater market power. Efficient structure theory provides support for positive nexus between market concentration and profitability of commercial banks which is based on an indirect consequence of bank efficiency. Empirical studies have provided mixed results on bank competitiveness and profitability relationship. Some of the empirical works documented positive nexus while others found negative nexus between bank competitiveness and profitability.
Keywords: Bank Competitiveness, Profitability and Banking Sector
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I. Introduction

The pursuit for profitability in the banking industry often leads to competitiveness where inefficient market players exit the industry as a result of rising competitive forces. Bank competitiveness is a dynamic process which leads to the elimination of inefficient players from the market where the remaining number of market players is at equilibrium, thereby bringing about efficiency and the required levels of return on investment in the market (Genchev, 2012; Karkrah & Ameyaw, 2010). The existence of banks goes beyond the acceptance of customers' deposits but ultimately for purposes of providing the deficit sectors with loans. Charging of interest on loans serves as the major incentive of financial intermediation. This intermediation role is however influenced by stiff bank competitiveness as it is hinged on the capacity and ability of banking institutions to generate sufficient profits (Yahaya, Farouk, Yahaya, Yusuf & Isah, 2015).

In the banking industry, bank competitiveness is good, as it enhances intermediation efficiency of banks, reduces prices, and increases choice and innovation (Mdoe, 2017). For many sectors, increased competitiveness is recommended; however, one cannot have too much competitiveness (Yahaya *et al*., 2015). Every industry is characterized by unique underlying structures. In the context of banking, competitiveness refers to the way by which banks manage their competencies so as to maximize profits and ensure stability, given the existing regulatory and structural frameworks (Musau, Muathe & Mwangi, 2018). The banking sector is characterized by high increasing returns to scale; therefore, it is advantageous to be bigger (Khrawish, 2011). In respect to the increasing returns to scale in the industry, banks often have to attain a critical mass to become profitable. Thus, the importance of competitiveness in the banking sector (Ajisafe & Akinlo, 2014). As a result of the intense competitiveness in the financial system, banks usually are highly leveraged, liquid and more complex as compared to other profit making institutions (Ali, Akhtar & Ahmed, 2011).

II. Theoretical Literature Review

There are two underlying theories that provide explanations to the degree by which bank competitiveness impacts on the profitability of commercial banks. The market power hypothesis (also regarded as the structure-conduct-performance hypothesis) and the efficiency structure theory. The market power hypothesis proposes that banking industries with higher levels of concentration are characterized by increasing profitability which is influenced by the various benefits of having greater market power (Yahaya *et al*., 2015). This is reflected in the setting of high prices for products and services (high interest rates on loans to borrowers and low deposit rates to depositors) which are often less favorable to consumers as a result of imperfect competition (monopoly profit) in the industry (Ntow & Laryea, 2012).

Stronger levels of competitiveness however, do not necessarily translate to higher profitability levels. The hypothesis of structure-conduct-performance (SCP) proposes that in a market where there is high concentration and lower competitiveness, banks individually strive to achieve abnormal (monopolistic) profits (Akinkunmi, 2017). The market power of a bank can therefore be reflected in its profitability level (Janger & Schmidt-Dengler, 2010). The SCP hypothesis proposes that, as market concentration tends to increase, profitability should have a downward trend that is if there is no collusive behavior among firms (players) in the market (Hu & Xie, 2016). On the other hand, if the profitability of banks is on the increase accompanied by rising concentration, the implication is that commercial banks in the market are colluding for purposes of reaping oligopoly profits (Yahaya *et al*., 2015). This notion therefore rests on the view that market structure has an influence on the conduct (behavior) of banks, which subsequently affects profitability.

In a banking industry with high bank competitiveness, commercial banks are likely to exhibit collusive behaviour, as such the oligopoly rents of these banks increase profitability (Hu & Xie, 2016). Conversely, the efficient structure theory provides support for positive nexus between market concentration and profitability of commercial banks which is based on an indirect consequence of bank efficiency (Janger & Schmidt-Dengler, 2010). This proposes that increases in the levels of bank efficiency leads to higher profitability in the banking industry.

III. Empirical Literature Review

A number of studies have been done on bank competitiveness and profitability. Mdoe (2017) studied competition and profitability relationships with respect to commercial banks in Kenya. The study was based on a balanced panel data focusing on thirty six commercial banks for the years 2001- 2014. The study findings indicated that, concentration reduces bank profitability in the short run; however, in the long run concentration increases profitability of banks.

Abel and Le Roux (2016) evaluated the determinants of profitability in the banking sector of Zimbabwe. The time scope of the study was the years 2009 Q1 to 2014 Q2 which also covers the period of multicurrency system adoption. The study which was based on panel (fixed effect) regression methodology revealed that, bank specifics are the key drivers of profitability in the banking sector of Zimbabwe. Concentration had an insignificant negative effect on bank profitability in Zimbabwe.

Ajide and Ajileye (2015) analyzed the effect of market concentration on profitability in the Nigerian banking industry. Profitability which was the dependent variable was proxied using return on capital employed while the Concentration Ratio (CRL) was used as the predictor variable. The study applied time series (aggregate level) data ranging from the years 1991 to 2012. Findings from the analysis indicated that, market concentration had a negative and insignificant effect on profitability. The study findings negate the market power hypothesis which stipulates a positive relationship between market concentration and profitability of banks.

Yahaya *et al*. (2015) studied the impact of competition on financial performance of commercial banks in the context of Nigeria. The study focused on the fifteen listed commercial banks for the time period 2005 to 2014 with a total number of one hundred and fifty (150) observations. Competition was the independent variable which was proxied by market share. Using multiple regression analysis, findings of the study indicated a negative relationship between competition and financial performance. The study recommended that bank regulators should ensure a healthy competition in the sector as this will curb its negative effect on financial performance of banks.

Osuagwu (2014) explored the determinants of bank profitability in Nigeria. Profitability of banks was assessed in terms of net interest margin, return on assets and return on equity. Consequently, market power was measured using the Herfindahl Hirschman Index (sum of squares of market share of each bank). The study utilized panel data methodology focusing on the time scope spanning from the years 1980-2010. The results from the panel regression technique indicated that, market power (HHI) had a significant negative effect on all the profitability measures used in the study. The negative effect implied that the increase in market power resulted in corresponding decrease in bank profitability.

Sayedi (2014) evaluated the effect of market power on profitability of commercial banks in Nigeria. Bank profitability was assessed using return on equity and return on assets. The study population comprised of fifteen (15) listed commercial banks at the Nigerian Stock Exchange. The study utilized secondary data for the period 2006 to 2011. The study applied regression analysis and found that, market power had significant positive effect on profitability (return on assets). The model for return on equity indicated that, market power had significant positive effect on profitability of listed commercial banks in Nigeria. The study recommended that the managers of commercial banks should strive to increase and sustain market power (market share).

Genchev (2012) studied the nexus between market share and bank profitability in Bulgaria. The study aimed at exploring the effect of various factors (which include market share and industry concentration) on profitability of banks in Bulgaria. Balanced panel data was utilized which was based on twenty two (22) banks for the time frame 2006 through 2010. The study adopted return on equity as a measure of profitability. The study hypothesis was that, leading banks (in terms of market share) should generate higher profitability. In line with this, the findings indicated that, market share had a positive and significant nexus with profitability. Therefore, confirming the notion that the larger the market share of banks, the better the ability to earn higher profitability.

IV. Summary and Conclusion

Theoretically, different prepositions have been provided to underpin bank competitiveness and profitability nexus. In view of market power hypothesis, banking industries with higher levels of concentration are characterized by increasing profitability which is influenced by the underlying benefits of having greater market power. Efficient structure theory provides support for positive nexus between market concentration and profitability of commercial banks which is based on an indirect consequence of bank efficiency. Empirical studies have provided mixed results on bank competitiveness and profitability relationship. Some of the empirical works documented positive nexus while others presented negative nexus between bank competitiveness and profitability.

V. Contribution to Knowledge

The study contributes to knowledge is different ways. The study provides theoretical underpinnings with regards to the underlying associations between bank competitiveness and profitability with focus on the banking sector. Additionally, a review of previous studies on the subject matter further provides diverse empirical evidence on the relationship between bank competitiveness and profitability based on various contexts.

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