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CONTENTS

FINANCIAL PERFORMANCE OF BANKS IN SELECTED AFRICAN COUNTRIES: DOES INSTITUTIONAL QUALITY MATTER?

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Abstract
The importance of the banking sector to any nation's development cannot be overemphasized due to its ability to provide the loanable funds required for investment and capital formation. However, the decline in the financial performance of banks in Africa coupled with weak institutions prevalent in most countries in Africa have limited the banks' capacity to effectively stimulate economic prosperity. Hence, this study examined the effect of institutional quality on the financial performance of banks in selected African countries. The study population consisted of the 1017 banks operating in Africa from 2010 to 2020. Yamane formula and random cluster sampling was employed to select the top 200 banks in terms of assets, profits and size in Africa as at 2020. The study employed secondary data obtained from the Bank Focus database and the World Development Indicator. System Generalized Method of Moment was employed as the estimation technique. Findings revealed that institutional quality positively and significantly affects bank financial performance in selected African countries. Consequently, this study concluded that institutional quality is an important driver of bank financial performance. Thus, this study recommended that the selected countries' governments promote policies that would strengthen their nation's institutions because of their ability to further improve banks' financial performance.

Keywords: Institutional Quality, Financial Performance, Banks, GMM.

1. Introduction
The banking sector is perhaps one of the most important financial intermediaries in any nation because of its ability to provide the capital required for economic activities. The role played by banks is germane for economic prosperity, particularly in emerging markets where capital markets are still developing (Aziz & Knusten, 2019). Banks seem to be the foremost formal institution where individuals and enterprises can approach for funds to improve their businesses (Aluko & Ajayi, 2017). A viable banking sector is better positioned to contest adverse shocks and contribute to the solidity of the financial structure. Hence, the issues that may stimulate bank financial performance have attracted academicians, bank management, financial markets, regulators, and investors (Levine, 1999).

A country's institutional quality is one of the major factors that influence how businesses perform within the country (Aluko & Ajayi, 2017). The indices for measuring institutional quality design by World Bank (Worldwide Governance Indicators) provided six wide-ranging indicators for measuring governance quality. The indices are Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption. Evaluation of institutional quality varies from an average of -2.5 (weak) to 2.5 (strong) (Kaufmann *et al*., 2003).

The numbers of Africans utilising banking services currently have improved over what is obtainable in previous years. However, the banks operating in the African continent are still faced with a decline in their financial performance (Kanika, 2019). The study conducted by Euromoney in 2019 established that the devaluation of local currencies had contributed significantly to why banks operating in Africa cannot compete with their European counterparts in terms of profitability. An unfavourable working environment coupled with excessive regulations has contributed to why some foreign-owned banks like Barclay's bank, BNP Paribas, Credit Suisse, and HSBC have reduced their African stakes. Some banks are selling off their assets and leaving the continent outright (Kanika, 2019).

Different studies (Altman, 2007; Azman-Sain *et al*., 2010; Brkic 2020; De Haan & Sturm, 2000) have established that institutional quality significantly affects economic growth and the Foreign Direct Investment (FDI) of any nation. However, literature on the relationship between institutional quality and bank financial performance in Africa is relatively scarce. These inadequate studies in this regard are somewhat surprising, given the role banks play in stimulating economic growth and development (Chinn & Ito, 2007; Levine, 1999) and the influence that institutional quality may have on the banking sector, especially in Africa. Therefore, this study seeks to extend the research work on bank financial performance in an emerging market (with emphasis on Africa) and establish (if any) empirically the nexus between institutional quality and banks' financial performance in selected countries of Africa. Studies on bank performance are common in the literature (Albertazzi & Gambacorta, 2009; Athanasoglou *et al*., 2008; Dietrich & Wanzenried, 2011; Park & Weber, 2006; Pasiouras & Kosmidou, 2007). However, not much has been done on how institutional quality affects banks' financial performance, especially in Africa.

The African banking sector requires special attention because most African banks have experienced notable reforms in the past three decades (World Bank, 2019). The state predominantly owned most of the banks in the 1980s, and as such, the banking sector is well-regulated, like interest rate ceiling and foreign exchange control. In addition, trade liberalisation and globalisation have changed the face of financial systems across the region (World Bank, 2019). Most of Africa's countries now have a profound and more stable financial system, despite the infrastructural deficit, inefficient capital market, poor governance, and limited financial inclusion (Beck & Cull, 2013). Nevertheless, as the institutional quality index for most African countries ranked below the globally acceptable standard (World Bank, 2019), the question arises about how banks' financial performance will be affected. Will African banks have an improvement in their financial performance? Thus, this study seeks to contribute to the extant literature by examining the effect of institutional quality on bank financial performance in selected African countries.

2. Literature Review

The relationship between institutional quality and bank financial performance in selected African countries can be explained in the context of the law and finance theory. As propounded by LaPorta, Lopez-de-Silanes, Shleifer and Vishny in their study (Law and Finance) published in 1998. The theory stressed the significance of law in developing an efficient and effective financial system. The theory is divided into two major parts. The first part concentrated on the legal structure. The legal structure emphasises that in countries with an efficient and effective legal system where contractual agreements are judiciously followed, contractual obligations are well entrenched in the countries' laws. Such countries have a higher chance of having a better and improved financial sector. The second aspect of the

theory recognises the legal background as one reason for differences amongst nations, especially in their banking sector development level.

The theory further argues that nations whose legal background can be attributed to common law tend to be more advanced than nations whose legal structure originated from civil law custom. However, the study of Oto-Peralias and Romero-Availa (2014) nevertheless postulated that common law nations do not necessarily have a more advanced financial sector than their counterparts in civil law nations, especially where there are higher levels of natural resources in both countries. Fowowe (2014) however contradicts law and finance theory by empirically pointing out that legal background does not justify why the African banking sector development is not as developed as their European counterpart. In line with this theory, this study hypothesises that an improvement in the country's institutional quality would positively affect the financial performance of banks.

On whether institutional quality influences bank performance, Alessandro and Panagiotos (2018), Bulow (2015), Issar *et al*. (2017), Kaouthar and Mondher (2014), and Rajesh and Kunal (2017) all agreed that the quality of institutions influences bank performance. They infer further that a vibrant institution protects investors, promotes trust, and increases bank efficiency. They equally established that government impartiality builds confidence in banks, encourages investments and supports financial sector development. Similarly, Oladele (2021) equally established that institutional quality is one of the major drivers of bank financial performance in Africa. Therefore, the study recommended that various governments in Africa pursue policies that improve the country's institutional quality. Ali *et al*. (2017) equally justified their claim that political stability and market risks are the main drivers of Islamic banks' profitability in Yemen. With the sample drawn from SSA, Aluko and Ajayi (2017), Minhaj *et al.* (2020) concluded that bank performances and the development of the entire financial sector are significantly inspired by the quality of the country's institution, the level of the country's openness, the extent of nations liberalisation, and macroeconomic factors. Ahmed (2013), Hourani and Mondello (2019), and Mutarindwa *et al.* (2018) contended that institutional quality and an efficient legal system improve the governance of banking institutions encourage different categories of banks to increase their credit facilities which ultimately enhances their financial performance.

Similarly, Elkelish and Tucker (2016) opined that legal framework and respect for private properties significantly affect bank performance. They, however, could not find established if political structure stimulates bank performance. Chan *et al.* (2015) study equally supported the arguments that market structure and institutional framework determine bank performance, especially in the ASEAN countries. Some studies (Anayiotos & Toroyan, 2009; Faiz *et al*., 2011; Filippidis & Katrakilidis, 2014; Law & Demetriades, 2006; Le *et al.*, 2016; Mbuluwa, 2015) equally provided robust argument to substantiate their claim that the quality of countries institutions significantly influenced financial sector development and bank performance.

3. Methodology and Model Specification

This study relied on the *ex post facto* research design because the study is relying on data that is already available; hence, data manipulation is minimal. The data for the study were sourced from the Bank Focus database and the World Development Indicator database. The dependent variable (ROA) was lagged in the regressor to introduce dynamism into the model. The choice of dynamism was based on the assumption that past bank performance can affect future performances (Aluko & Ajayi, 2017).

This study's population consisted of 1017 operating in the 54 African countries as of 2020. This study employed the Yamani (1967) formula to determine the sample size because of data constraints. The procedure used to derive the sampling frame is N/ (1+ N(e^2)). Based on Yamane's (1967) formula, the sample size is one hundred (200). This study then employs random cluster sampling to select the top two hundred (200) banks in Africa in terms of assets, deposits, and revenue in 2020 (The Africa Report, 2020) in order to increase the sample size's confidence level. The selected banks operate in 33 (Mauritius, Cameroon, Egypt, Sudan, Tunisia, Angola, Mozambique, Morocco, Burundi, Gabon, Zambia, Ghana, Senegal, South Africa, Zimbabwe, Burkina Faso, Mali, Malawi, Tanzania, Benin, Botswana, Cote d'Ivoire, Democratic Republic of Congo, Congo Republic, Nigeria, Algeria, Togo, Ethiopia, Kenya, Namibia, Libya, Rwanda, and Uganda) out of the 54 countries in Africa. The values for the chosen bank have been converted to dollars, thus eliminating exchange rate differences. The eventual sample is an unbalanced panel dataset of 200 banks spanning from 2010 to 2020. The year 2010 was selected as the base year for the study because the data of banks that were hitherto not captured in previous years was incorporated into the BankFocus database. The study could not be extended beyond 2020 because the database of Bankfocus has not been updated beyond 2020 as at the time of carrying out this study. Return on Assets (ROA) and Return on Equity (ROE) was employed as the measure of bank financial performance while the aggregate score of the six indices (Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption) of institutional quality was employed as the measure of institutional quality.

The study utilised both descriptive and inferential statistics as the estimation technique. Mean, minimum, maximum, and coefficient of variation were employed for the descriptive statistics. In contrast, the System Generalised Method of Moment (SGMM) was employed to estimate inferential statistics. The SGMM is very appropriate for the study because of the lagged value in the regressor. SGMM is designed for panels with few time-series observations per individual and a large sample in cross-section dimensions. When applied to panel data models, it takes care of probable endogeneity of all explanatory variables, measurement errors, and misplaced variables.
This study specifies a dynamic panel model to examine the effect of institutional quality on bank financial performance. This approach aligns with studies like Aluko and Ajayi (2017), Oladele (2021) that built a dynamic panel model for their respective studies on bank performance. Hence, the study listed a law and finance model variant that regressed financial performance on an institutional quality measure.

The model is stated as follows:
Bank Financial Performance is a *f* (INSTQ + control variables)
The model is further broken down as ROA = *f* (INSTQ + INF + GDP + FDI)
The model is now expressed econometrically as:

$$ROA_{it} = \alpha + \beta_1 ROA_{it-1} + \beta_2 INSTQ_{it} + \beta_3 INF_{it} + \beta_4 GDP_{it} + \beta_5 FDI_{it} + \mu_i + \varepsilon_{it}$$

For the alternate method of measuring bank performance, the model is stated as:

$$ROE_{it} = \alpha + \beta_1 ROE_{it-1} + \beta_2 INSTQ_{it} + \beta_3 INF_{it} + \beta_4 GDP_{it} + \beta_5 FDI_{it} + \mu_i + \varepsilon_{it}$$

Where: **α:** constant term, **ROA:** Return on Asset, **ROA_{it-1}:** Lag of return on asset, **ROE:** Return of Equity, **INSTQ:** Institutional quality, **INF:** Inflation, **GDP:** Gross Domestic Product, **FDI:** Foreign Direct Investment, **μ_i**: Unobserved bank/country-specific effect, **ε:** error term, **$\beta_{1\text{-}5}$:** parameters of the explanatory variables, **t:** time period, **i:** banks/countries involved.

***Note*:** INF, GDP, and FDI were incorporated in the model as control variables because they have been identified in the literature (Aluko & Ajayi, 2017; Minhaj *et al.*, 2020; Oladele, 2021) as having the power to affect bank financial performance.

4. Results and Discussion of Findings

Table 1: Descriptive Statistics

Variable	Observation	Mean	Std. Dev.	Coe. of Var.	Min.	Max.
ROA	1,426	2.236111	2.382118	1.065295	-7.83	27.93
ROE	1,427	17.95213	16.09615	0.89662	-167.45	155.37
INSTQ	1,393	-0.5513286	0.6641332	1.20457	-2.441388	0.881436
INF	1,406	6.525984	5.778849	0.88551	-2.4	41.5
GDP	1,410	3.503358	3.579672	1.02178	-61	13.606
FDI	1,430	2.566506	4.137028	1.61193	-6.369877	39.4562

Source: Author's Computation (2022).

The summary statistics of ROA, ROE, INSTQ, Inflation, GDP and FDI for the banks and nations under review are presented in Table 1. ROA has a mean score of 2.23611, indicating that, on average, the selected banks have been relatively profitable in the years under review. However, the profitability of the banks measured by ROA is not evenly spread. For example, with a minimum value of -7.83 and a maximum value of 27.93, the significant difference between the minimum and the maximum value indicates that while some banks have reported a considerable improvement in their financial performance, others have seen a sharp decline in their profitability. On the other hand, the standard deviation value of 2.382118 shows that the ROA of banks in the years under review have not experienced high volatility. However, ROE recorded a much higher average than ROA, as inferred from the mean score of 17.952. The result shows that the selected banks perform better when the Return of shareholders' wealth is considered. However, the standard deviation value of 16.096 indicates higher volatility on the selected banks' ROE. The higher volatility in ROE may be attributed to how the selected banks' shares are traded in their respective countries' stock markets.

The mean score of Institutional quality has a mean score of -0.5513. This implies that the selected countries' institutional quality can be regarded as weak. Hence, institutional problems are still a major challenge in the countries under consideration. With a standard deviation of 0.6641 for institutional quality, one can infer those institutional challenges are persistent in the selected African countries. The sharp contrast between the minimum and the maximum value of institutional quality is an indication that some countries under review have a better institution in place than others. Inflation has a mean score of 6.525984 in the period under review, indicating that inflation is relatively high in the countries under review. However, it is essential to note that the level of inflation in each country is not evenly spread. A minimum score of -2.4 and a maximum score of 41.5 shows the significant difference among the levels in each country, especially in the year under review. Also, the standard deviation of 5.778849 indicated that inflation has been relatively volatile in the period under consideration.

Gross Domestic Product (GDP) has a mean score of 3.503358. The score indicates that the GDP of the selected African countries has grown at a relatively good pace. However, the

growth in GDP is not evenly spread, especially in the years under review. With a minimum score of -61 and a maximum score of 13.606, there is a clear indication that the growth of countries in the years under consideration have not been evenly spread. The Foreign Direct Investment (FDI) has a mean value of 2.566506. The value indicates that, on average, there has been an increase of 2.57% in the FDI inflow into the selected countries in the years under review. However, the significant difference between the minimum value (-6.369877) and the maximum value (39.4562) indicates that the FDI inflow in the countries under review is not evenly spread, especially in the year under consideration. Furthermore, the FDI has the highest coefficient value of 1.61193%, indicating a high variation in the FDI across countries. However, INF has the lowest coefficient value of 0.88551% and suggests a low variation in the INF of the countries under review.

Table: 2 Multicollinearity Test

VARIABLE	**VIF**	**1/VIF**
INSTQ	4.91	0.203807
INF	1.51	0.662239
GDP	1.26	0.791555
FDI	1.10	0.912878
Mean VIF	**2.196**	

Source: Author's Computation (2022).

Multicollinearity occurs when there is evidence of a strong linear relationship among the independent variables in a regression model. Variance Inflation Factors (VIF) can test the degree of linear relationship among the independent variables in a model. Using the VIF test, the rule of thumb is that the value for a variable must not exceed 10 to confirm that it is not highly collinear. Gujarati (2007) opined that for variables not to be heavily collinear, the VIF test result should be below five while the tolerance level (1/VIF) should be closer to one. The VIF result, as shown in Table 2, shows that the independent variables in the regression model have a VIF value less than five, and a tolerance level is closer to one, indicating that the model is not likely to suffer from the issue of multicollinearity. Also, the mean of the variables (2.196) shows that the variables do not have a strong linear relationship.

Model Estimations

This study relies on the dynamic panel model's two-step system Generalised Method of Moments (GMM) estimator. This estimator is valid when the Arellano-Bond (AB) test for serial correlation fail to reject the presence of first-order serial correlation [AR (1)] but rejects the existence of second-order correlation [AR (2)]. Similarly, the Hansen test must not reject the hypothesis of over-identifying restrictions, confirming that the instruments used are orthogonal to the error term, proving their validity. Also, instrument proliferation should be avoided by keeping the number of instruments below the number of cross-sections (banks).

Table 3. SGMM Result for institutional Quality

C	**Coefficient**	**P-value**
Constant	2.24495	0.000***
ROA_{t-1}	0.2557626	0.019**

INSTQ	0.4109569	0.006***
INF	0.0506966	0.041**
GDP	0.0428077	0.067*
FDI	0.0153513	0.541
Model Diagnostics		
AR (1) Test	-2.99	0.024**
AR (2) Test	-1.02	0.307
Wald x^2	36.47	0.004***
Hansen test	5.56	0.162
No. of Observations	1181	
No. of Banks	200	
No. of Instruments	8	

Notes: ***, **, and * indicate statistical significance at 1%, 5%, and 10% significance level, respectively.

Source: Author's Computation (2022).

The regression result in Table 3. revealed that the lagged ROA is positive and has a statistically significant coefficient (0.2557626, P-value 0.019), justifying the introduction of dynamism into the model. The positive and statistically significant coefficient of lagged ROA equally explained the argument that banks' past financial performance influences the present and future performance. Institutional Quality (INSTQ) has a positive and statistically significant coefficient (0.4109569, P-value 0.006), implying that institutional quality positively affects banks' financial performance in the selected African countries. The finding also indicated that as nations make concerted efforts to improve their various institutions' quality, bank financial performance increases. Improvement in institutional quality connotes accountability, political stability, law rule, regulatory quality, government businesses' effectiveness, and corruption control. The general improvement in these areas improves bank financial performance. Inflation and GDP provided a positive and statistically significant coefficient indicating that bank financial performance increases when inflation and GDP rises. FDI, however, did not give a significant result, implying that FDI does not affect bank financial performance.

Table 4. SGMM Result for Institutional Quality

Variable	**Coefficient**	**P-value**
Constant	9.366699	0.000***
ROA_{t-1}	0.3671161	0.005**
INSTQ	0.1256466	0.030**
INF	0.0879795	0.265
GDP	0.1651762	0.071*

FDI	0.1749654	0.345
Model Diagnostics		
AR (1) Test	-2.30	0.022**
AR (2) Test	1.44	0.150
Wald x^2	35.94	0.000***
Hansen test	8.16	0.319
No. of Observations	1183	
No. of Banks	200	
No. of Instruments	13	

Notes: ***, **, and * indicate statistical significance at 1%, 5%, and 10% significance level, respectively.

Source: Author's Computation (2022).

The lagged ROE in the regression result in Table 4. is positive and statistically significant, validating the argument that past performance influences bank financial performance. The coefficient (0.3671161) and P-value (0.005) results similarly provided a statistical justification for the model's dynamic nature. Institutional quality (INSTQ) has a positive and statistically significant coefficient (0.1256466, P-value 0.030), indicating that institutional quality increases banks' financial performance. Institutional quality, however, has a higher coefficient on ROA (0.4109569) than what is obtainable with ROE. This implies that while ROA and ROE positively affect bank performance, the effect is higher on bank ROA than the ROE. The finding shows the importance of institutional quality in improving banks' financial performance. It produces a consistent result with the two methods (ROA & ROE) employed to proxy banks' financial performance in the selected African countries. Only GDP has a positive and statistically significant effect on banks' financial performance for the control variables.

The regression result shows that institutional quality has a positive and statistically significant effect on banks' financial performance in the selected African countries. The result also gave a consistent result among the different proxies of bank financial performance. The consistency shows how improved and efficient government institutions, political stability, quality regulation, and corruption control can positively and significantly improve bank financial performance. Hence, as nations, institutional quality improves, the financial performance of banks operating in those countries increases. The finding also supports the law and finance theory which states that a fair and efficient regulatory framework that protect investors and financial institutions promotes an efficient and profitable banking system. The result supports the findings of Ahmed (2013), Anayiotos and Toroyan (2009), Faiz *et al*. (2011), Filippidis and Katrakilidis (2014), Hourani and Mondello (2019), Mutarindwa *et al.* (2018) and Oladele (2021) that institutional quality and efficient legal system improves the governance of banking institutions, encourage different categories of banks to increase their credit facilities which ultimately enhances their financial performance.

The regression results also show that inflation has a positive and statistically significant effect on banks' financial performance in the selected African countries. A consistent and sustained rise in commodity price (inflation) benefits the bank by increasing its financial performance.

During inflation, the increase in banks' financial performance may be attributed to a rise in demand for bank facilities (loans) for individuals and businesses to increase demand for their goods and services. The result provided statistical support to Aluko and Ajayi (2017) Mohammed (2014) that macroeconomic variables like inflation improve the banking sector development and the financial performance of banks. However, Chang (2002) and Chang and Caudil (2005) had a contrary view.

Gross Domestic Product (GDP) has a positive and statistically significant effect on banks' financial performance in the selected African countries. This implies that as the nation's GDP increases, the financial performance of banks operating in those countries increases. The finding also provided statistical support for the studies of Aluko and Ajayi (2017), Nelson and Singh (2013) and Subasat and Bellos (2011) that an increase in GDP stimulates the growth of the banking sector. On the other hand, foreign Direct Investment (FDI) does not significantly affect the financial performance of banks in selected African countries. This implies that regardless of the changes in FDI, the financial performance of banks would remain unaffected. The outcome, however, contradicts the findings of Hichem and Lassad (2018) that an increase in FDI can improve bank financial performance.

5. Conclusion and Policy Recommendations

Base on the findings of the study, this study concluded INSTQ, inflation and GDP are the major drivers of bank financial performance in selected African countries. In addition, the study established that the financial performance of banks would remain unchanged regardless of the changes in FDI. The study infers further financial performance of banks in the selected countries would see a significant improvement if measures are put in place to further strengthen the nation's institutions. Thus, this study recommended that the selected countries' governments should promote policies that would strengthen their nation's institutions because of its ability to further improve the financial performance of banks.

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