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Enhancing Internal Factors Unlocks Profit in Saudi Banks: Meningkatkan Faktor Internal Membuka Laba di Bank-bank Arab Saudi

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Abstract

General Background: Banks' profitability is crucial for financial stability and economic growth. **Specific Background:** Internal factors such as capital adequacy, asset quality, and management effectiveness play a significant role in determining profitability. However, the impact of these variables on Saudi banks needs further exploration. **Knowledge Gap:** Existing research lacks a comprehensive analysis of how these internal variables affect the profitability of Saudi banks over a long period. **Aims:** This study examines the effect of changes in capital adequacy, asset quality, management effectiveness, and liquidity on the bank profit index, measured by the return on assets (ROA) at Saudi Fransi Bank from 2000 to 2022. **Results:** Quantitative analysis reveals that capital adequacy and asset quality have a significant positive impact on ROA, with 1% increases in each leading to 20% and 76% increases in ROA, respectively. In contrast, increased liquidity and management inefficiency negatively affect ROA, decreasing it by 33% and a significant margin, respectively. The internal variables account for about 96.4% of the variation in profitability. **Novelty:** This study offers a detailed long-term analysis of internal factors affecting bank profitability in Saudi Arabia. **Implications:** Enhancing assetquality and management effectiveness is crucial for improving profitability and reducing costs, benefiting both Banque Saudi Fransi and the broader banking sector.

Highlights:

- Positive Impact: Capital adequacy and asset quality enhance bank profitability.
- Negative Impact: Higher liquidity and management inefficiency reduce profitability.
- High Explanatory Power: Internal variables explain 96.4% of profitability variation.

Keywords: Bank Profitability, Return on Assets, Capital Adequacy, Asset Quality, Management Effectiveness

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Introduction

The allocation of economic resources for countries is greatly aided by commercial banks. In another sense, banks must be profitable in addition to performing the mediation function in order to function sustainably as you direct depositor money to investors continuously. If you are able to generate the income required to cover your operational costs, which you bear over time, then they can accomplish this. Countries' economic growth is significantly impacted by bank finances. An rise in investment and economic growth are the results of rewarding those who perform well financially [1]. Negative effects on economic growth, however, might result from a crisis and bank failure caused by subpar banking performance.

Comprehending the factors that influence bank profitability is crucial for investors, financial analysts, and policymakers as it may reveal the industry's adaptability and resilience in the face of economic challenges[2].

The goal of this study is to determine how internal factors at the Saudi Fransi Bank, a well-known financial institution in the Kingdom of Saudi Arabia, affect the bank profitability index. The study's time frame is from 2000 to 2022, which saw significant shifts in the local and worldwide economies as well as advancements in technology and regulations that surely had an impact on the banking industry's performance. A useful case study to comprehend the wider impacts of internal factors on banking profitability in the Region is the performance of Banque Saudi Fransi. [3]

This study explores the internal factors that influence bank profitability in attempts to provide valuable insights to policymaker, association leaders, and bank executives. To improve sustainable and profitable banking operations, these visions can aid in the formulation of well-informed plans, the improvement of risk management procedures, and the improvement of internal processes.

This research paper's structure is set out as follows: Based on current ideas and experimental research, the literature on banking profitability and determinants will be reviewed in the following section. The approval process, which includes data collection, variable selection, and analytical technique, will be determined in the third section. The results will then be presented and analyzed in the fourth section, which will also extract the effects of the most obtained recent data. The study will be concluded in the last section with an overview of the key findings, the implications of the banking industry, and recommendations for future studies.

The first topic: theoretical framework

Literature Review

Using a range of techniques, several studies on the performance of the global banking industry and financial safety have been carried out. According to research published in 1973 by McKinnon and Levine [4], the financial system's ability to lower information and transaction costs has a significant impact on how quickly people save money, make investments, develop new technologies, and, ultimately, expand their economies. in [5], Hassan and Bashir A research that looked at Islamic banks worldwide between 2001 and 1994 in order to identify the factors that affected their profitability. The study came to the conclusion that high capital and lending rates to assets boost profitability, and that implicit and explicit taxes have a negative impact on a bank's performance while macroeconomic economic conditions have a favorable impact on performance metrics. Kosmidou & et al. did the study in 2005. to talk about how quantified credit risks—measured in terms of loan losses—relate to the performance of British banks. The findings show that although the reserves of loan losses have a positive net interest margin, their negative effect on bank earnings is negligible.

A study conducted in 2009 by Sufian & Habibullah looked at 37 commercial banks in Bangladesh from 1997 to 2004. The study found that while bank size has a negative impact on return on average equity (ROAE), bank loan density, credit risk, and cost have positive and substantial effects on bank performance. Additionally, the study looked at the influence of macroeconomic indicators and came to the conclusion that all of the variables—aside from inflation, which has a negative link with the profitability of Bangladeshi banks—do not significantly affect the profitability of banks.

Ameur & Mhiri [6] examined the performance of 10 commercial banks in Tunisia between 1998 and 2011 in order to identify the variables that account for these banks' achievements. This research covered variables that impact the bank's performance in addition to variables pertaining to the banking sector and the overall economy. The findings showed that the administrative proficiency of the bank and its formation both positively and significantly affect the bank's performance. The study also found that industry-related factors, such attention, had a detrimental and substantial effect on performance. Furthermore, the performance of the bank is not much impacted by the indicators of the overall economy[7].

In a 2014 research, Adam The purpose of the study is to evaluate the financial performance of the Investment and Finance Bank (Erbil) in the Kurdistan region of Iraq from 2009 to 2013. The three dependent variables are the rate of return on property rights, the rate of return on deposits, and the rate of return on assets. The analysis comes to the conclusion that the bank's interest rates, asset quality, and liquidity rates have all improved. The study also came to the conclusion that the return on assets is inversely correlated with bank size and operational effectiveness[9].

Study Islam & Nishiyama [9] The profitability of banks in South Asian countries using GMM methods to analyze the painting data. Note a positive connection between the return on assets and the interest rate.

The size of the bank (BS) and stocks to assets and deposits have a higher influence on the profitability of the traditional

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bank, according to research by Alzoubi Alzoubi [10] and Alhassen et al [11] on the profitability of Jordanian banks. El-Kassem's [12] study discovered that, in contrast to an independent variable like "cost to income," which has a significant and negative impact on the variation in the bank's performance, an external variable like "total capital ratio" has a significant and positive impact on the performance of the bank.

HOSEN [13] conducted an investigation on 23 commercial banks in Bangladesh and found that the performance of the bank is significantly influenced by the spread of interest rates, capital adequacy, and liquidity. According to a research by * Et Al Lestaria [14], bank size has a favorable effect on profitability whereas liquidity and leverage have a negative one. Et al. * Iskandar [15] examined the Malaysian banking industry and discovered that a variety of elements, including profit variable, asset structure, capital, and liquidity, are crucial to a bank's profitability. These elements also include administrative competence, liquidity risks, and credit risks. [16]

The internal factors affecting the profitability of the bank:

a. Return on assets ROA:- This financial metric indicates the bank's capacity to generate returns on its asset investments [17]. It primarily relies on how much money is made from these assets. Due to the fact that it gauges the profitability of all of the bank's short- and long-term investments, it is also known as return on investment. Al-Mashhadani [18] This indicator, which is calculated by dividing net profit by total assets, also indicates the efficacy and efficiency of management in managing assets and provides trust in its financial management, soundness of investment decisions, and operational decisions made [19]

The percentage of return on assets = (profit is clear)/(total assets) *100…….(1)

b. Liquidity LR:- The bank's liquidity indicates how quickly it can meet an unexpected need for cash. As a result, the bank has to have a strong liquidity stock that is moved from financial assets in order to readily offer liquidity. In order for financial assets to be considered liquid, they must be made available to their owners in a timely manner. [20]

c. The quality of the assets AQ:- The quality of the bank's assets is one of the crucial factors that may be utilized to assess the performance or strength of the institution. The primary goal of assessing asset quality is to determine the non-operating asset component as a percentage of total assets (2014* ifacho). A high percentage indicates a rise in bank depositor volume, which boosts profitability, and it is assumed that there is a positive correlation between profitability and the caliber of assets in commercial banks [21]

d. Management efficiency ratio EM:- (Revenues to Expenditures) The performance of financial institutions, like other institutions, is greatly impacted by the safety of the administration because a high ratio of expenses to income may indicate that the financial institution is not operating efficiently, which may be the result of inefficient administration and income. [22]

Methods

The second topic is the practical aspect:

Specific model and data:

The return on assets (ROA), which stands for the dependent variable, was the primary authorized performance indicator employed. Capital adequacy (CR), asset quality (QA), management effectiveness (EM), and liquidity level (LR) are the independent factors (internal variables) that need to be The data from the Saudi Fransi Bank is represented by certain proportions, and the slope analysis was applied in a normal small squares format for the period spanning 2000–2022. The suggested format was as follows:

$$RO= a +\beta_1CR + \beta_2AQ+\beta_3LR+\beta_4EM+ Ut……(2)$$

Whereas(Ut)It represents an error limit

Test the relationship relationship between study variables:-

Table (1) demonstrates a strong positive correlation between the capital capital sufficiency index and the dependent variable on assets, ROA, as well as a strong positive correlation (0.798949) between the return on assets and the asset quality, or AQ. In contrast, the correlation between the return variable and the independent variables, LR (and EM), was negative, indicating a reverse relationship.

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Table 1. The correlation between variables

	ROA	CR	AQ	LR	EM
ROA	1				
CR	0.052157	1			
AQ	0.798949	0.423649	1		
LR	-0.021362	0.540371	0.26425	1	
EM	-0.75242	0.314773	-0.233340	0.249527	1

Source: The table is prepared by the researcher based on the annual financial reports of the Saudi Fransi Bank for the period (2000-2022).

View and discuss the results:- Table (2) represents the results of the slope analysis of the selected variables

Table 2. Results of slope analysis, accredited variable (RO) rate of return on assets

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-1.747748	0.242607	-7.204041	0.0000
CR	0.209143	0.108951	1.919608	0.0709
AQ	0.764189	0.122876	6.219186	0.0000
LR	-0.330327	0.141347	-2.336997	0.0312
EM	-1.018215	0.116642	-8.729441	0.0000
R-squared 0.964 Adjusted R-squared F-statistic	0.957 123.8579	Durbin-Watson stat		2.377014
Prob(F-statistic)	0.000000			

Result and Discussion

A minimal degree of confidence, 96%, is indicated by the slope analysis findings. According to the alternative hypothesis, which claims that the bank's variables have a significant influence on the Saudi-France Bank's financial performance during the research period, the hypothesis of nothingness is rejected in light of the aforementioned data.

A one percent increase in the Capital Sufficiency Variable (CR) results in a twenty percent increase in the return on assets, which is consistent with the findings of each of the following studies: [23][24]

According to a study conducted in 2014 by Pratibha Yadav and Harold Ngalawa, the asset quality variable (AQ) positively impacted the rate of return on assets. Specifically, a 1% increase in asset quality results in a 76% increase in the rate of return.

Since liquid assets, such as cash in the fund and government securities, have a relatively low return overall, holding them imposes the cost of an alternative opportunity, the liquidity variable (LR) had a negative effect on the rate of return on assets. Increasing liquidity by 1% results in a 33% decrease in the rate of return. beside the bank. As the company's profitability is maximized by liquid assets, it is fair to assume that the banks would maintain them in the absence of the organization, and this is what is signaled to it [25].

According to the study [26], the findings indicate a negative influence on the percentage of management efficiency for total expenses relative to total income. This is to be expected.

As a result, the ratio of costs to revenues needs to be closely monitored. An increase in one unit of this ratio has the consequence of decreasing banks' profitability by a sum equal to (-1.018215).

Conclusion

1. The research found that the Capital Capital Sufficiency (CR) has a positive and moral relationship between the adequacy of capital and the bank's profitability (ROA). The increase in the adequacy of capital by 1% leads to an increase in the return on assets by 20%, which indicates that banks with good capital tend to achieve a higher profit.

2. As for the quality of assets (AQ), a positive and strong relationship between the quality of the assets and the return on

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the assets was observed. The increase of 1% in the quality of assets leads to an increase of 76% in the return on assets. This indicates that maintaining a higher quality of assets positively affects profitability.

3. While the research was found that liquidity (LR) negatively affects profitability. Increased liquidity by 1% leads to a decrease in the return on assets by 33%. This can be attributed to the cost of an alternative opportunity to keep liquid assets, which tend to achieve fewer returns.

4. As for the management efficiency (EM) variable, the research found a negative effect of management efficiency on banks' profitability. A higher expense-to-revenue (EM) ratio results in a lower return on assets. This is consistent with expectations that effective management can contribute to increased profitability

5. The slope analysis shows that the chosen internal variables explain together approximately 96.4% of the difference in the bank's profitability. This strong explanatory force indicates that the internal factors have a significant impact on the bank's financial performance under study of the Saudi Fransi Bank throughout the study period.

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