Innovations

The effect of financial risks on financial performance of private commercial banks in Ethiopia

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Abstract

The effect of financial risk has been considered to be an important issue on the performance of Ethiopian private commercial banks. This study empirically examines the effect of financial risks on performance of private commercial banks of Ethiopia and interprets the result by relating with the regulations. The study used OLS regression model in examining the regression model and collect data from ten private banks covering the period of ten (10) consecutive years (i.e. 2012-2022). To this end, the study employed a mixed method research approach by combining documentary analysis and unstructured in-depth interviews. The study used panel data techniques on the regression analysis and used E-view9 software package. The study used one dependent variable return on asset (ROA), seven independent variables that are capital adequacy risk, credit risk, liquidity risk, interest rate risk, foreign exchange rate to operating cost risk, loan to deposit risk, and deposit to asset risk. The regression result show that credit risk, liquidity risk and foreign exchange rate risk were statistically negative effect at 1% significance level on performance of private commercial banks in Ethiopia whereas liquidity risk and interest rate risk had negative insignificant effect on performance Ethiopian commercial banks. Furtherer, the results from the panel regression suggest that capital adequacy, operating efficiency and loan to deposit has a positive and significant effect at 1% significant level on financial performance. However, deposit to asset ratio has a positive and insignificant impact on performance of private banks in Ethiopia. The research concluded that financial risks have significant effect on the performance of Ethiopian private commercial banks. Hence, the study recommend in support of each variables for Ethiopian private commercial banks to give due attention on financial risk to enhance their performance significantly.

Key words: 1.*Effect, 2.Financial risk management, 3.financial Performance 4. Ethiopian private commercial banks*

1. Introduction

Risk is one of the sward sides of doing business taken to boost the other desirable outcome of being profitable. In fact, managing risk is certainly not a new concept to businesses and their management teams (Turget, 2018). However, as discussed by Mark and Richard (2011), the concept of financial risk management in banking arose in the 1990s and risk management before the 1990s was used to explain the techniques and risks related to insurance. Earlier, this kind of risk management refers to the purchase of traditional insurance products that are suitable for any events to protect from future hazards. Recently in the financial markets, derivatives have also been recognized as risk management tools to use for hedging activity risk management practices and processes have continued to develop, along with a growing awareness of risk. Although there was until a few years ago no accepted framework or standard that could be used to establish or evaluate risk management activities.

Financial risk is the unexpected variability or volatility of returns (Holton, 2004). It includes credit, liquidity and market risks which contribute to the volatility of financial performance (Tafri et *al*., 2009). In addition, Karen (2005)defined financial risk as a process to deal with the uncertainties resulting from different factors that financial institution facing. It consists identifying the financial risks facing an institution and developing management strategies consistent with internal priorities and policies. By addressing financial risk issue, financial institution may secure competitive advantage in market.The hypothesis is that financial risk leads into failure of financial performance if it is not well managed. The financial crisis acquires unparalleled proportions and inflicted long-term damage on economies, countries and people. Every business decision and entrepreneurial act is connected with risk.

Financial risk is any type of danger that can result in the loss of capital to interested parties. Financial risks arise from different sources that relates with financial institution involvement in uncertain business operation. Some of these factors are credit risk, operational risk, liquidity risk, market risk, funding risk and etc. First considering the broader aspect of the macroeconomic condition that means an organization's exposure to changes in market prices, such as interest rates, exchange rates, and commodity prices can be considered as one source of financial risks. Second, the action and transaction of financial firm with other organization such as vendors, customers, and counterparties in derivatives transactions. Finally, the failure of institutions to control internal action, particularly people, processes, and systems would trigger financial risks to happen (Ibid).

Financial risk is an umbrella term for multiple categories of risk associated with financial transactions. It can further be explained as the possibility where the investors lose money if they are investing in the company whose cash flows are inadequate to meet the matured obligations (Arif and Showket, 2015).

As the findings of different studies show that risk management in financial institutions is a landmark to fair and acceptable banking practice. Today, financial institution are facing unstable and uncertain money related environment and such firms reacting for various risks to be specific credit hazard, liquidity risks, capital adequacy risk, interest rate and financing cost risks and so on. If these risks failed to be managed properly, financial institution will lead to bankruptcy (Carey, 2001).

The concept of risk management process in banking area raises various basic questions. These matters remark the needs of having the practice of financial risk management in bank. As mentioned by Turgut (2018), these issues include investigating the activities of the banks that are creating risk or losses and also assessing the potential damage that those risks could cause; actions or activities that can be implemented by

the banks to address these potential hazards, and monitoring and reporting usually take place as the last part of the risk management practices for checking and reporting the activities of bank risk management.

Bank plays very significant role in the economies of the nation. The well-being of the economy is highly related to the soundness of its banking system. When the bank faces adverse situation to handle financial risk, the economy of the countries will also fall into challenge. Financial institutions, particularly, commercial banks serve as intermediaries between money suppliers and those who are in need of it (Anteneh, 2018).

According to Brenda (2013) in addition to traditional banking service, banks offer various financial service and they are making technologically advanced service based on to their customer preference. The complex and competitive nature of banks increases by the changing and expanding role of the economy. For survival and growth of this business demands creativity, specialization and knowledge and adoption of new technology are used. But technology, creativity, specialization all these cannot support a bank to survive unless the services are marketed in the right track. For this banks need experts who will able to run the business even in against the wind.

In Ethiopia, according to Birhanu (2012), commercial banks are playing an important primary role as financial intermediaries in the economic growth process, channeling funds from savers to borrowers for investment. As financial intermediaries, banks play an important role in the operation of an economy. In such away, commercial banks are key providers of funds and their stability is of paramount importance to the financial system.

Although, state owned banks have a dominant role in Ethiopian banking market, the participation of the private commercial banks in the economy has been dramatically showing a good progress after the liberalization of the sector for private Ethiopian investors; still the door is closed for foreign participants. Notably, the ownership difference is assumed to bring efficiency to the market and the share of private commercial banks has been increasing from time to time. In fact, the market is highly controlled by the regulatory body but still the private banks are using the little room given for competition in the mixed economy. Since the unhealthy condition of the banking sector may result instability to the whole economy, they are highly controlled by the National Bank of Ethiopia. Besides, these companies need to gage their condition and situation with respect to the level of risk, among other; financial risk should get much of the attention (Solomon, 2019). Therefore, this study sought to fill the existing research gaps having a main research question of what is effect of financial risks on financial performance of private commercial banks in Ethiopia?

2. Theoretical Overview and Hypothesis Development

Financial Performance (FP)

The study employed return on assets (ROA) to measure financial performance of Ethiopian private commercial banks. Daniel et al. (2013) mentioned that return on total assets (ROA) is calculated as net profit before tax by total assets. This is probably the most important single ratio in comparing the efficiency and financial performance of commercial banks as it indicates the returns generated from the assets that banks own. In addition, as stated by Ana-Maria et al. (2014), the return on total assets ratio represents one of the most used methods of quantifying financial performance.

Capital Adequacy Risk (CAR)

The ratio of Core Capital to Total Risk Weighted Assets is a risk sensitive measure of capital that is used (Obwogi, Kosimbei&Nasieku 2013). The ratio measures the amount of a bank's capital in relation to the amount of its risk weighted credit exposures. The risk weighting process takes into account the relative riskiness of various types of credit exposures that banks have, and incorporates the effect of off-balance sheet contracts on credit risk. The higher the ratios a bank has, the greater the level of unexpected losses it can absorb before becoming insolvent.

H_1: Capital adequacy has statistically significant and positive effect on the financial performance of the private commercial banks in Ethiopia.

Liquidity Risk (LR)

Liquidity risk is the probability a bank will not have sufficient cash and borrowing capacity to meetdeposit withdrawals, loan demand and other cash needs. It is also the inability to manage changes in funding resources. Basically, liquidity risk also come from the failure to recognize changes in market conditions that affect the ability to liquidate assets quickly with the minimum losses. Thus, liquidity risk can say to be a crucial measure for bank's profitability**.**

The current ratio is chosen to represent the liquidity risk of the banks in this paper. Current ratio is the most popular measure of liquidity risk. It is the ratio which indicates the efficiency of a bank operating cycle to turn its assets into cash. The higher the ratio, the more capable the bank is of paying its obligations.

$$Liquaidity\ Risk = \frac{Current\ Assets}{Current\ Liabilities}$$

H_2: Liquidity risk has statistically significant and positive effect on the financial performance of the private commercial banks in Ethiopia.

Credit Risk (CR)

Credit risk is the risk that borrower unable to make payment on loan. Credit risk is calculated based on the borrowers' overall capability to repay. There are many ways to calculate credit risk such as nonperforming loan, and risk weighted assets. However, loan loss provision to total loans is used to assess credit risk in this research. It is the allowance that set aside for bad loans. Bank need to increase the amount for loan loss provision when it is exposed to high risk loan. This is due to there is high growth of unpaid loans. Higher loan loss provision ratio will reduce the net income and earnings per share. The lower the ratio, the better it is for banks.

$$Credit\ Risk = \frac{Loss\ loan\ provision}{Total\ loans}$$

H_3: Credit risk has statistically significant and negative effect on the financial performance of the private commercial banks in Ethiopia.

Interest Rate Risk (IRR)

Interest rate risk is the changes in asset value due to unexpected changes in interest rate. The real interest rate risk is used to evaluate the interest rate risk for this research. The reason is because the real interest is a

more accurate indicator than nominal interest rate and it does not consider of the inflation rate. It reflects the real cost of borrowing to the borrower and the real return to the lender.

H_4: Interest rate risk has statistically significant and positive effect on the financial performance of the private commercial banks in Ethiopia.

Foreign Exchange Rate Risk (FERR)

Foreign Exchange risk arises when a bank holds assets or liabilities in foreign currencies and impacts the earnings and capital of bank due to the fluctuations in the exchange rates. No one can predict what the exchange rate will be in the next period, it can move in either upward or downward direction regardless of what the estimates and predictions were. This uncertain movement poses a threat to the earnings and capital of bank, if such a movement is in undesired and unanticipated direction (Boahen& Evans, 2014). Acaravci&Calim (2013) Turkish banking sector's profitability factors found positive relationship between exchange rate and profitability. Thus, this variable has significant and positive impact on profitability. Official exchange rate refers to the exchange rate determined by national authorities or to the rate determined in the legally sanctioned exchange market. It is calculated as an annual average based on monthly averages (local currency units relative to the U.S. dollar).

H_5: Foreign exchange rate risk has statistically significant and negative effect on the financial performance of the private commercial banks in Ethiopia.

Total Loan to Total Deposit Ratio Risk (TLTD)

It is calculated as ratio of total liabilities to total assets and represented that when there is inability existed for a company to meet its long-term fixed expenses and to accomplish long term expansion and growth (Sommer, 1996). Solvency risk (total loan to total deposit ratio risk) is about a company's inability to meet its financial obligations. A company is said to be solvent if it can meet its obligations and insolvent if it cannot.

H_6: Total loan to total deposit has statistically significant and positive effect on the financial performance of the private commercial banks in Ethiopia.

Total Deposit to Total Asset Risk

According to Kwan (2000), deposits to asset ratio measures the magnitude of assets being funded by public deposits. He further stated that the Deposit-to-Asset Ratio tests whether banks that have more deposits incur additional operating costs to attract deposit

H_7: Total deposit to total asset ratio has statistically significant and positive effect on the financial performance of the private commercial banks in Ethiopia.

3. Methodology

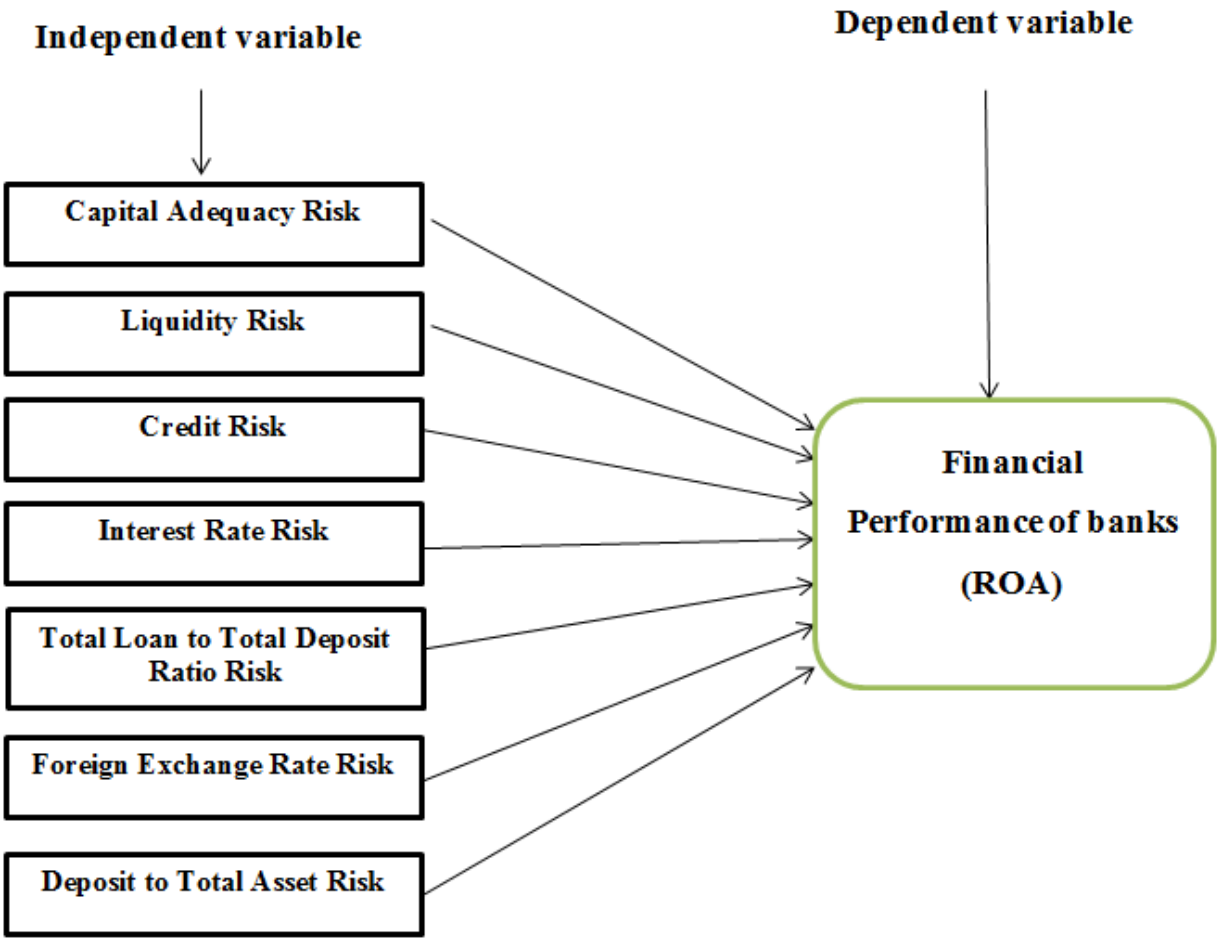
The study used explanatory research design. An explanatory types of research design is important for a research types if the dependent variable affected by several independent variables (Muranaga and Ohsawa, 2002). Hence, different financial risks were used to evaluate their effect on the performance of the banks. Studies that establish causal relationships between variables may be termed explanatory research. The emphasis of explanatory research is on studying a situation or a problem in order to explain the relationships between variables (Mark, Philip and Andrean, 2009). Therefore, explanatory research design was employed

in this research because the study identified the causal and effect relationship of financial risks and Ethiopian private commercial banks' financial performance through multiple linear regressions.

To draw a sample from the population, the research was applied purposive sampling methods. Hence, the study covered a period of ten years (10 years from 2012-2021) and the sample of the study containing Awash Bank S.C, Dashen Bank S.C, Bank of Abyssinia S.C, Wegagen Bank S.C, United Bank S.C., Nib International Bank S.C., Corporate Bank of Oromia S.C, Oromia International Bank, Lion International Bank S.C. and Zemen Bank S.C. The selection criterion is based on the age of the banks.

To test the proposed hypotheses, inferential statistical analyses were carried out. The inferential test regression analysis was used to test the relationship between the variables (See figure 1). Correlations, and regression analysis with Random effect model were done to test whether there is relationship between dependent variable and explanatory variables and to measure the effect of variables on financial performance.

Figure 1: Conceptual Framework



Source: Researchers' own construction based on literatures, 2021

The nature of the data which was used in this study is both time series and cross-sectional data that enable to use panel/longitudinal data model which are deemed to have advantages over cross sectional and time series data methodology.

Thus panel/longitudinal regression model was used as follows:

$y = \alpha + \beta it\ x + uit$

Where:

- y represents the dependent variable, which is the bank's financial performance(FP);
- X contains the set of explanatory variables in the model mentioned above, which are capital adequacy risk (CAR), Liquidity Risk (LR), Credit Risk(CR), Interest rate risk (IRR), Total loan to total deposit ratio risk(TLTDRR), Foreign Exchange Rate Risk (FERR) and Deposit to total asset risk(DTAR) ;
- uit is the disturbance term;
- α is taken to be constant over time t and specific to the individual cross-sectional unit ,

- i and t denote the cross-sectional and time-series dimension respectively

FP it= ƒ(CAR, LR, CR, IRR, TLTDRR, FERR,DTAR, u)

The banks financial performance was regressed against the independent variables, by the equation below.

FPit = β0 + β1CARit + β2LRit + β3CRit + β4IRR it + β5TLTDRRit + β6FERRit + β6DTARit+ u

Where FP: Financial performance in time t

CAR= capital adequacy risk in time t

LR = liquidity risk in time t

CR = Credit risk in time t

IRR = Interest rate risk in time t

TLTDRR = total loan to total deposit ratio risk in time t

FERR= Foreign Exchange Rate Risk in time t

DTAAR= deposit to total asset risk in time t

u = random disturbance term and

β = regression coefficient

4. Result and Discussions

4.1. Introduction

The effects of financial risk management on financial performance of banking sectors have been studied by many researchers across the world. However, apart from other shortcomings as mentioned on statement of the problem, the literature lacks more evidence regarding Ethiopian private commercial banks context. Thus, this study was conducted to examine the effects of financial risk management on performance of Ethiopian private commercial banks to add its own effort for the empirical evidence. The banks that are included in this study were all senior private commercial banks those operate before 2012. In case, the data for this study was drawn from ten commercial banks for ten years (2012 to 2021 periods). To this end, 100 observations were analyzed to achieve the objectives of the study.

The data analysis procedures used for ratio scale measurement and the ratio of the specified dependent and independent variables were calculated for further statistical analysis. The collected data was analyzed by the aid of the statistical software of Eview9.

4.2. Results of Regression Analysis

Table 1: Regression Result

Dependent Variable: ROA
Method: Least Squares
Date: 04/03/2022 Time: 16:34
Sample: 1 100
Included observations: 100

Variable	Coefficient	Std. Error	t-Statistic	Prob.
CAR	0.163309	0.025089	6.509130	0.0000
LR	0.011457	0.003868	2.961646	0.0039
CR	-0.179105	0.039621	-4.520430	0.0000
IRR	0.000595	0.000978	0.608842	0.5441
FERR	-0.006731	0.001060	-6.348817	0.0000
TLTD	0.015872	0.008685	1.827490	0.0709
TDTA	0.009400	0.008363	1.124012	0.2639
C	0.007746	0.011545	0.670995	0.5039

R-squared	0.764516	Mean dependent var	0.035622
Adjusted R-squared	0.746599	S.D. dependent var	0.011506
S.E. of regression	0.005792	Akaike info criterion	-7.388138
Sum squared resid	0.003086	Schwarz criterion	-7.179724
Log likelihood	377.4069	Hannan-Quinn criter.	-7.303789
F-statistic	42.66922	Durbin-Watson stat	1.879575
Prob(F-statistic)	0.000000		

Source: ComputedfromE-views9result (2021)

Besides, as table 1 depicted that the coefficient of capital adequacy risk, liquidity risk, interest rate risk, total loan to total deposit and total deposit to total asset ratio relationship with ROA were positive as far as the coefficients for those variables were 0.163309, 0.011457, 0.000595, 0.015872 and 0.009400 respectively. This indicates that there was direct relationship between these aforementioned five independent variables and ROA. In other words these financial elements have positive effects on performance of private banks in Ethiopia regardless of their significance. Thus, the increase of those variables will lead to increase in ROA

On the other hand, variables like credit risk and operating efficiency had a negative relationship with financial performance of private commercial banks in Ethiopia as far as their respective coefficients were -0.179105 and -0.006731. This revealed that there was inverse relationship between the above three independent

variables and ROA. Considerable increment on credit and foreign exchange rate risk would adversely affect the performance of private commercial banks of Ethiopia. In general as per the regression results provided in table 1 among the seven repressors used in this study five of them was significant at different level.

In general, the regression result of this study revealed that there was a significant relationship between financial risks and financial performance of private commercial banks in Ethiopia. Furthermore, the remaining results of the documentary analysis and primary data were used to assess the impact that exists between financial risk and performance of private commercial banks of Ethiopia (ROA).

4.3. Hypotheses Testing

The analysis is based on the results of the documentary analysis mainly using the results of the regression analysis between the dependent variable and the independent variables presented in table 1.

Capital Adequacy

H_1: Capital adequacy risk has statistically significant and positive effect on performance of private commercial banks of Ethiopia.

The coefficient of capital strength which is measured by the equity to total assets ratio was positive and statistically significant at 1% significance level (p-value = 00.0000). The magnitude of the coefficient estimate (0.163309) was relatively higher next to credit risk as compared to other variables which indicated the existence of strong positive relationship between capital and financial performance. The regression results implies that every one percent change (increase) in the capital adequacy keeping the other things constant had a resultant change of 16.33% on the banks' performance in the same direction. This finding of the result was consistent with different literatures that. According toDei-Ofosu &Amoh (2016),Eniyew (2013), capital strength affects Ethiopian banks of performance and its influence was significant. Generally, the researchers fail to reject the first hypothesis

Liquidity Risk

H_2: liquidity risk has statistically significant and positive effects on performance of private commercial banks of Ethiopia.

Concerning the liquidity risk, the regression results of this study implies that the relation between liquidity risk and ROA was positive and statistically significant 5% level as the p- values revealed (p-value=0.0039). The variable, liquid assets to total assets ratio was used as a proxy for liquidity in the model. The result indicates that the liquidity variable had significant and positive effect on bank financial performance. This implies that high or lower figures for this variable have tremendous effects on performance of banks. Therefore, the researchers accepted the second hypothesis.

Credit Risk

H_3: Credit risk has statistically significant and negative effect on Ethiopia insurance companies' performance.

According to the regression result of credit risk (CR) has a negative relationship with Ethiopian private banks performance by a coefficient estimate of -0.179106. The output result of p value of credit risk (CR) is 0.0000 reveals that it is statistically significant at 1% level of significance. Further, the magnitude of the coefficient estimate was relatively higher as compared to other variables which indicated the existence of strong negative relationship between credit risk and financial performance. This means that holding other independent variables constant and when one percent increases in credit risk, consequently it reduces return

on asset (ROA) of Ethiopian private banks by 17.91%. This outcome is consistent with prior study of Lambe (2015), Emawayih (2017), Arjata and Mirinda (2018) and Tesfaye (2018) that point out the negative significant effect of credit risk on performance of banks. This implies that the hypothesis is supported.

Interest Rate Risk

H_4:Interest rate risk has statistically significant and positive effect on the performance of the private commercial banks of Ethiopia

As per the result of regression analysis, statistically interest rate risk had positive and statistically insignificant relationship with performance of Ethiopian private banks performance by a coefficient estimate of 0.000595. This indicates that the fourth hypothesis is not supported.

Foreign Exchange Rate Risk

H_5: Foreign exchange rate risk ratio has statistically significant and negative effect on the performance of the private commercial banks of Ethiopia

The coefficient of the ratio of cost to income, which provides information on the efficiency of the financial institutions regarding how the resource were used to generate income, was positively and statistically significant at 1% significance level (p-value=0.0000) which is in line with a prior expectation and makes the variable an important determinant of Ethiopian private banks performance. This showed that minimizing commercial banks costs in Ethiopia would certainly improve the banks performance in general. The negative relationship between foreign exchange rate and profitability in Ethiopia private commercial banks indicates that increased exchange rate would enhance performance of private banks in Ethiopia. The result was consistent with the findings of Dawit (2017) and Kenny, Omowunmi, and Faderera (2014) who conclude that higher efficiency in exchange rate would result higher profitability of banks. Hence, the hypothesis is supported.

Total Loan to Total Deposit

H_6: Total loan to total deposit has statistically significant and positive effect on Ethiopia commercial banks performance.

As the regression result discloses that total loan to total deposit (TLTD) has a positive relationship with Ethiopian commercial banks performance by a coefficient estimate of 0. 0.015872. The p value of TLTD is 0.0709 which discloses that it is statistically significant at 10% level. This means that holding other independent variables constant and when one percent increases in total loan to total deposit, as a result it increase return on asset (ROA) of Ethiopian commercial banks by 1.58% and the result supported the working hypothesis that total loan to total deposit has positive and statistically significant effect on Ethiopia commercial banks performance. The implication of this result is an increase in loan to deposit ratio leads to a higher financial performance and a decrease in loan to deposit ratio leads to lower performance in the case of private commercial banks in Ethiopia Hence, this is the result of the interest rate difference between what the banks charging on loan and what they actually paying on the deposits. Thus, this outcome is consistent with prior study of Worku (2016), concluded that there is a positive effect between total loan and advance to total deposit and performance of commercial banks in Ethiopia.

Total Deposit to Total Asset

H_7: Total deposit to total asset ratio has statistically significant and positive effect on the performance of the private commercial banks of Ethiopia.

The coefficient estimate of deposit to asset expected to positive significant effect on financial performance of banks. The regression analysis output showed that deposit to asset ratio has a positive insignificant effect on financial performance of private banks in Ethiopia. The coefficient estimate of this explanatory variable was 0.009400 with p- value of 0.2672. This result implies that deposit to asset ratio has positive effects on financial performance of private banks in Ethiopia. Though deposit to asset ratio has a direct relationship, it has statistical insignificance impacts on the performance of private banks in Ethiopia was minor. This indicates that the fourth hypothesis is not supported.

5. Conclusions

The empirical findings on the impact financial risk management on performance of private banks in Ethiopian for the sample suggest the following conclusions.

Capital adequacy is the major determinants of private commercial banks performance of Ethiopia. The positive and statistically significant relationship between capital adequacy and performance of targeted bank was in line to hypothesis of the study. This coefficient statistically significant positive relationship with the performance private banks in Ethiopia indicated that when banks under study increase their capital, their return on asset will also increase.

Likewise capital adequacy, liquidity risk measured by liquid asset to total asset had statistical positive significant effects on the financial performance of private commercial banks in Ethiopia. This implies that that bank with high liquid asset had better financial performance. In other words, increase in ratio of liquid asset to total asset certainly leads to increase in financial performance. The outcome of this analysis was meeting the expectation of the hypothesis of the study.

Further, among positively and significant variables, loan to deposit ratio was also in consistent the hypothesis constructed in the study. Definitely, incremental of loan to deposit will also leads to increase in financial performance targeted banks of this study

The result point toward that negative and significant association between credit risk and Ethiopian private commercial banks performance which implies the increase in credit risk inevitably lead to a decline in the performance of the private banks due to the likely hood of debtors failing to honor their obligation to the banks.

Despite their positive effect, interest rate risk and total deposit to total asset had insignificant impact on performance of private banks in Ethiopia. This implies that an increase in interest rate risk and deposit to asset certainly not lead to affect the performance of private commercial banks in Ethiopia. These explanatory variables were not with the expected relation of ROA as outlined in the hypothesis.

6. Managerial implications

There is need for private commercial banks to consider enhance liquid asset more as it is found to have influence on financial performance. Considerable losses might result if the banks were failed to manage properly liquidity. Therefore, Ethiopian banks should have optimal level of liquidity which enables banks to meet their contractual commitments.

Private Banks in Ethiopia should have to give prior focus to operating efficiency. While controlling operating costs of these banks, maximum efforts should have to be excreted to enhance the level of operating income. Commercial private banks in Ethiopia are also advised to increase the income resulted from non-interest

income like fee and commission as it is found to have the highest positive influence on banks profitability. In line with, private commercial banks also recommended focusing on reducing their operating expenses specially their salary and rent expense as it is found to have the highest impact on efficiency which in turn significantly affect financial performance of private commercial banks.

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