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INVESTMENT DIVERSIFICATION AND PERFORMANCE IN THE NIGERIAN BANKING INDUSTRY

KASUM, Abubakar Sadiq: Department of Accounting, University of Ilorin, Ilorin, Nigeria

FAGBEMI, Temitope Olamide: Department of Accounting, University of Ilorin, Ilorin, Nigeria

ZAKARIYAH, MonsuratLanre: Department of Accounting, University of Ilorin, Ilorin, Nigeria

Abstract

Investment diversification is an important process in risk management. It enable investors to considerably reduce their risk without compromising their return. One of the reasons that investment diversification is very important is because some commercial banks activities are also carried out by other institutions like discount houses and other non-bank financial. As a result of such harsh competition the profit margin of these financial institutions have reduced. This will leave the banks with no option than to seek alternatives if they must continue to survive. In view of this, the study examines the option investment diversification as an alternative to the very dynamically competitive environment that banks now find themselves. The study employed secondary data obtained from the financial statement of Nigerian banks. Panel least square regression technique was employed in the study. The results of the regression analysis revealed that investment diversification will improve the management of Nigerian banking industry. Conclusively, Losses in one sector or location can be compensated from the gain(s) obtained from other sector or location and therefore reduces the risk involve in investing in a very risky asset. The study therefore, recommends investment diversification to Nigerian banks and that financial institutions should take into consideration the strategic decisions of risk and return preferences before diversifying.

Keywords: Investment Diversification; Nigeria Banking Institutions; Efficient Management

1. Introduction

The environment which financial institutions operate is of great concern to investors all over the world due to uncertainty, complex, dynamic and unpredictable nature of the environment. The development from this environment and the need for organization to survive in the fiercely competitive world poses risk. Besides, financial institutions hold many financial assets that constitute risk which has led organizations to device different strategies such as mergers and acquisition in order to survive, grow and compensate all stakeholders in the unfolding dispensation. It is worthy to note that the global financial markets are affected by globalization and specific country or regional factors which mean that the overall amounts of risks will vary.

The need to diversify their activities in order to survive harsh competition arose because commercial banks activities have been hijacked by discount houses and other finance houses. As a result of harsh competition, the profit margin of commercial banks has reduced. Also the investment options facing these institutions are either overvalued or undervalued and the consequences are usually pronounced that in so many cases they have led to bank failures. Through diversification, financial intermediaries reduce the risk of losing a substantial amount of funds in a short time.

Studies like Lubatkin, and Chatterjee, 1994; Cotugno and Stefanelli, 2012 shown that diversification improves profitability over time while others like Palich, Cardinal and miller 2000; Markides and Williamson, 1994 did not conclude on the interrelationship. Similarly, the need to repossession has

prompted the management of financial institutions to adopt diversification as a corporate strategy.

A well-developed financial sector facilitates high and sustainable economic growth (Hicks, 1969). Based on the position occupied by the banking sector in a country's economy, which it also occupied in the Nigerian economy. Whatever affect the banking sector have significant impact on other sectors and may affect the whole economy. It is therefore a sector that must continue to survive for other sector to continue to thrive and therefore cannot be neglected. In view of the forgoing, the study investigate the effect of investment diversification on performance of Nigerian banking institutions.

2.1 Conceptual Framework

2.1.1 Concept of Investment Diversification

Investment diversification has been defined by different scholars who have given divers definitions according to the scholars' interest. Reed and Luffman (1986) pointed out that the term diversification has different meanings when research interest varied. According to Penrose (1995) diversification refers to a firm's entry into a new market.

Diversification involves focusing on doing better what a company is already doing well by using existing strengths in new and productive ways without taking the risk of great shifts in direction. On the other hand, diversification is the strategy whereby a company sets up or acquires businesses outside its current products and markets (Kotler and Armstrong, 2008). It means the increase by a firm in the kinds of businesses which it operates, being that diversity either related to products, geographical markets or knowledge.

The technique of reducing the risk by investing in different types of assets is referred as diversification. In other words, diversification is a process of risk management that takes into account a broad selection of investments within a portfolio (Ikhlās and Saad 2012). They further stated that there are generally, two styles of diversification, one vertical diversification and the other horizontal diversification.

In case of horizontal diversification, an investor invests his capital in different types of a particular asset group. This mode of diversification is commonly observed in case of shares, where investors invest in shares of companies across industries and regions so as to reduce the sector-

specific perils. On the other hand, in vertical diversification, an investor invests his money among different categories of assets such as stocks, bonds, cash, property and derivatives among others. Portfolio diversification is crucial in the process of portfolio risk management because it enables the investors to considerably reduce their portfolio risk without compromising their portfolio return (Ikhlās and Saad 2012).

Therefore, it is imperative to examine portfolio risk and return for better understanding of portfolio diversification. The effect of portfolio risk in investment diversification cannot be completely ignored. Although, the degree of risk in businesses differs, some businesses are more exposed to high level of risk while other faces lower risk.

According to Begg, Fisher and Dornbush (1984) risk activities have two characteristics they are likely return on an investment and the degree of variation that is rate of changes of all the possible outcomes. Risk means that we know that certain things are bound to happen in future but the exact figure may not be predictable. The concept of risk may be defined as the possibility that the actual return may not be same as expected. In other words, risk refers to the chance that the actual outcome (return) from an investment will differ from an expected outcome. With reference to a firm, risk may be defined as the possibility that the actual outcome of a financial decision may not be same as estimated (Omisore, Munira and Nwufu, 2012).

Omisore, Munira and Nwufu, 2012 further stated that Risk should be differentiated from uncertainty; Risk is defined as a situation where the possibility of happening or non-happening of an event can be quantified and measured: while uncertainty is a situation where this possibility cannot be measured. However, there are two components of portfolio risk; the first one is non-systematic risk which can be diversified. The second one is systematic or non-diversifiable risk, which cannot be reduced by portfolio diversification; it is also called the market risk. However, return is the basic motivating force and the principal reward in any investment process. Returns may be defined in terms of realized return (that is, the return which has been earned) and expected return (that is, the return which the investor anticipates to earn over some future investment period). The expected return is a predicted or estimated return and may or may not occur. According to Anas (2014), the return is the

increase in wealth from holding a security over a given period of time. The return of the investor from a security must take into account both the capital appreciation and the dividends declared by the company.

2.1.2 Risk and Performance in the Financial Sector

Financial institutions behave differently to varying exposures of risk. Some institutions may accept moderate exposures while insuring against ones (Stulz, 1996). Thus commercial banks may accept credit risk but avoid interest rate risk. While an investment bank does the opposite (Kimball 2000). The extents to which managers mitigate risks are affected by the proportion of intangible assets and the ability to diversify firms' portfolio (Tufano, 1996). However, the risk of a portfolio depends not only on the risk of its securities, considered in isolation, but also on the extent to which they are affected similarly by underlying events.

A bank may find it difficult to survive the risk of loan default which leads to its liquidity being reduced but can do better and be prevented from becoming insolvent if it has a security or finance house or other viable subsidiary that sustains it in the short run. Other aspects of the firm's operations such as the convexity of its tax schedules, the ability of managers to diversify their portfolios and the proportion of intangible assets can also affect the extent to which managers attempt to mitigate risks.

2.1.3 Effects of Diversification on Performance of Financial Institutions

When financial institutions concentrate all their funds in one or few assets and the assets are perfectly correlated with each other, then the beneficial effects of diversification cannot be achieved by the financial institutions. However, by diversifying their liabilities, financial intermediaries reduce the risk of losing a substantial amount of funds in a short time. Such a loss could lead to a sudden shrinkage of assets because the total uses of funds must equal sources of funds (Ojo, 1999). He further stated that an unexpected shrinkage of assets could have detrimental effects on an intermediary if it were forced to sell assets at losses. Therefore, a portfolio that is diversified will have less risk in comparison to the weighted average risk of the constituent assets when the values of the assets do not fluctuate in a perfect synchrony (Ikhlās and Saad 2012). Ikhlās and Saad (2012) further opined that the rationale that guides this technique argues that a portfolio

consisting of different kinds of investment, on average, will give higher returns as well as posture a lower risk compared to any other individual investment that is found within the portfolio.

According to Ojo (1999), a life insurance company holds mostly corporate bonds and mortgages while commercial banks mostly hold loans of various types and a discount house holds treasury certificates, bank acceptances and commercial papers. The regulatory authorities of these financial institutions have restricted these various operations so they are somehow constrained and may not benefit from the diversification.

Anas (2014), opined that since financial intermediaries' portfolio contains many assets, it has to be constructed in a diversified way in order to avoid the risk, which may deprive investors from realizing the return that they have expected. Financial institutions can also diversify its operations into unrelated markets in order to realize economic benefits from the exploitation of an internal capital market (Shin, 2001).

It is worthy to note that the global financial markets are affected by globalization and specific country or regional factors which mean that the overall amounts of risks will vary, the most notable include: transparency and efficiency. Where, each country or region has different laws and regulations pertaining to their financial institutions. This means that the risks in a number of different institutions will depend upon specific market conditions themselves, reflecting these two factors. To protect themselves against these kinds of risks, many investors will often seek to diversify their portfolio across a variety of countries or regions (Anas, 2014).

2.2 Theoretical Background

This study is hinged on two theories, viz: The inverted U model and the intermediate model.

2.2.1 The Inverted U Model

Diversification across a small portfolio presents a strategy of restricted business where the firm focuses on a single industry, thus limiting opportunities to leverage resources and capabilities across divisions. Diversification and performance relationship in the form of inverted-U model described by Palich, Cardinal and Miller (2000); Lubatkin and Chatterjee (1994), said that performance is limited when a company is limited to single industry. Therefore the company does not have a chance to exploit the

benefits of synergies or the portfolio effect that are available only to moderately and highly diversified firms. These firms bear greater risk since they have not "diversified away" that risk by combining less than perfectly correlated financial streams from multiple businesses. This has negative implication for the debt capacity, cost of capital, and market performance of single business entities (Shleifer and Vishny, 1991).

2.2.2 The Intermediate Model

This model gives attention to the positive relationship between diversification and performance, but at degree of diminishing returns (Palich, Cardinal and Miller, 2000). It was argued that related diversifiers will outperform their unrelated counterparts only to the degree that they are able to exploit relatedness "to create and accumulate new strategic assets more quickly and cheaply than competitors" (Markides and Williamson, 1994). Markides (1992), however pointed out that as a firm increases in diversification, its moves further and further away from its core business, and the benefit of diversification at the margin decline

2.3 Empirical Studies

Anil and Narendar (1998) in their study on diversification and firm performance: an empirical evaluation, they classified 2188 firms in three groups: Single product firms, moderately diversified firms and highly diversified firms, the results of the study shows that on average diversified firms show better performance compared to undiversified firms on both risk and return dimensions.

Dunis and Shannon (2005) investigated equity markets of South-East Asia (Malaysia, Indonesia and the Philippines) and Central Asia (China, Korea, Taiwan and India) and found that in both samples, international diversification would be beneficial for investors from the US market. Bebczuk and Galindo (2008), analysed sectoral diversification of Argentine banks and suggested that larger banks benefit more from diversification than smaller ones and that the benefits of diversification are greater during the downside of the business cycle.

Sanya and Wolfe (2011), investigated the effect of revenue diversification on bank performance and risk for emerging economies and the findings of the study revealed that diversification decreases insolvency risk and enhance profitability. Rezayat and Yavas (2006) examined the short-term movements among five leading stock markets of: United State of America,

the United Kingdom, Germany, France and Japan, to evaluate the benefits of International Portfolio diversification they found out that despite the significant interdependencies among the markets studied, there appears to be still-room for international portfolio diversification. In particular, American investors can realize diversification benefits in Japan. On the other hand, diversification benefits are minimal for American and European investors who would like to invest exclusively in Europe or in the United state of America.

Mashiri and Sebele (2014), examined diversification as a corporate strategy and its effect on firm performance. : a study of Zimbabwean listed conglomerates in food and beverages sector. They employed primary and secondary data and found out in their study that there exists a positive linear relationship between diversification and firm performance.

Ugwuanyi, and Ugwu (2012), studied the effect of corporate diversification on the profitability of the financial services sector on Nigeria; the findings revealed that diversification impacts strongly on banks profitability.

2.4 Research Gaps and Contribution to Knowledge

Diversification is a process of risk management that takes into account a broad selection of investments within a portfolio. Many researchers agreed on the fact that there is no agreement on the precise nature of the relationship between diversification and performance (Palich, Cardinal and miller 2000; Markides and Williamson, 1994). Also some studies have shown that diversification improves profitability over time (Lubatkin, and Chatterjee, 1994; Cotugno and Stefanelli, 2012). The importance of this study stems from the fact that it will be of great benefit to practicing managers who might be willing to consider the usefulness of diversification in managing and strengthening their organizations. This study contributes to the existing body of knowledge by considering different activities that can be undertaken by commercial banks in Nigeria and also examine different banks in Nigeria.

3.1 Model Specification

The model specified below shall be used to ascertain the relationship that exists between portfolio diversification and financial institutions performance in Nigeria.

$$ROE = f(ID) \dots \dots \dots (1)$$

Where ROE= Return on Equity which is a proxy for banks performance, ID= Investment Diversification. Investment diversification will include loans and advances to customers, investment securities, investment in subsidiaries and investment property.

Thus equation 1 can be rewritten as:

$$ROE = f(LA, IS, IP, ISB) \dots \dots \dots (2)$$

Where LA= Loans & Advances to customer, IS= Investment Securities, IP= Investment Property and ISB= Investment in Subsidiaries.

Econometrically, it can be written thus:

$$ROE_i = \beta_0 + \beta_1 LA_i + \beta_2 IS_i + \beta_3 IP_i + \beta_4 ISB_i + \xi_i \dots \dots \dots (3)$$

Where ξ_i is the error term with zero mean and constant variance.

Apriori Expectation: The study's expected result is that there is going to be a positive relationship between investment diversification and performance in the industry.

3.2 Source of Data

Table 1: Correlation Matrix Table

	REQ	LA	ISB	IS	IP
REQ	1.000000	0.624250	-0.315961	0.414932	0.156114
LA	0.624250	1.000000	0.019903	0.548748	-0.106168
ISB	-0.315961	0.019903	1.000000	0.618455	-0.356917
IS	0.414932	0.548748	0.618455	1.000000	-0.327157
IP	0.156114	-0.106168	-0.356917	-0.327157	1.000000

Source: Authors' Computation, 2014.

The table above presents the correlation matrix between portfolio diversification and the performance of the sampled banks. The result above shows that most of the diversification made by banks yielded positive result on the banks performance. The loans and advances made to customers, investments in securities, investment in properties all had positive results on return on equity which is a proxy for banks performance while investment in subsidiaries reveals a negative correlation with the banks performance. Focusing or diversifying investment influence the

The data used for this study are financial data of institutions selected for the study. They were sourced from the annual report of the sampled financial institutions.

3.3 Method of Data Analysis

Regression analysis was used to estimate the extent to which investment data relate to performance data of the sampled financial institutions. This will reveal the relationship that exists between portfolio diversification and the financial institutions' performance.

4.0 Result and Conclusion

4.1 Data, Presentation and Analysis

This section presents the data analysis, interpretation and discussion of result. It also reflected on how portfolio diversification is a necessity to efficient management of financial institutions. The data collected are attached as appendix to the report.

4.1.1 Data Analysis

Correlation Matrix

A graphic relationship among the dependent and independent variables using their correlation matrix is as shown in the table below:

risk level that banks take on. Losses in one sector or location can be compensated from the gain(s) obtained from other sector or location. On the other hand, if the diversification level increases, it could lead to rising of costs under which diversification may not be associated with higher returns in these circumstances. Thus, it becomes advisable to make strategic decisions for a bank in cases of risk and return preferences.

The importance of investment diversification can also be shown in the regression result below.

Table 2: Regression analysis result.

Dependent Variable: REQ
Method: Panel Least Squares
Date: 11/13/14 Time: 19:16
Sample: 2009-2013
Periods included: 5
Cross-sections included: 5
Total panel (balanced) observations: 25

Variable	Coefficient	Std. Error	t-Statistic	Prob.
LA	4.58E-11	3.70E-11	1.238221	0.0300
ISB	-2.47E-09	5.24E-10	4.718394	-0.0001
IS	2.90E-10	6.68E-11	4.344764	0.0003
IP	7.76E-10	5.37E-10	1.444245	0.0642
C	0.083376	0.024590	3.390598	0.0029
R-squared	0.748206	Mean dependent var		0.157600
Adjusted R-squared	0.697847	S.D. dependent var		0.082426
S.E. of regression	0.045308	Akaike info criterion		-3.173802
Sum squared resid	0.041057	Schwarz criterion		-2.930027
Log likelihood	44.67253	Hannan-Quinn criter.		-3.106190
F-statistic	14.85747	Durbin-Watson stat		1.580185
Prob(F-statistic)	0.000009			

Source: Authors' Computation, 2014.

The table above shows the impact that investment diversification has on the performance of banks in Nigeria. All the signs of the coefficients conform to a-priori theoretical expectations. That is, they all have their expected positive signs which are in consonance with theory except for the coefficient of investment in subsidiaries. The probability value of these coefficients reveals the significance of these coefficients to influencing the sampled banks' performance. The investment in subsidiaries, investment in securities are highly significant in influencing banks performance at less than 1 percent level of significance, the probability value of the coefficient of loans and advances to customers reveals it is significant in influencing banks performance at less than 5 percent while the probability value of investment in properties indicates that it is significant in influencing banks' performance at less than 10 percent. The R-square shows that about 74 percent of the dependent variable is explained by the explanatory variables. The probability of the F-statistics shows the overall significance of the model which is significant at less than 1 percent. Thus, we can conclude that the model is of good fit.

4.1.2 Discussion of Findings

According to the definitions and interpretations of economic literature and banking sciences, diversification in any business should always reduce the level of risks. One of the biggest challenges in managing financial institutions is the management of risk involved in the business. The technique of reducing the risk by investing in different types of assets is referred as diversification. Ugwuanyi, and Ugwu (2012), in their study on effect of corporate diversification on the profitability of the financial services sector on Nigeria, revealed that diversification impacts strongly on banks profitability. Cotugno and Stefanelli (2012) also opined that diversification is useful in managing and strengthening organizational risk. However, the findings of this study revealed that portfolio diversification influences the risk level that banks take on. The result of the findings also revealed that most of the diversification made by banks yielded positive result on the banks performance.

5.1 Conclusion

This study examines investment diversification, a necessity to efficient management of banking institutions. Diversification involves focusing on doing better what a company is already doing well by

using existing strengths in new and productive ways without taking the risk of great shifts in direction. Investors are by nature risk averse and therefore seeking for different techniques of managing risk. . The study takes into consideration various investment options with the aim of investigating if investment diversification can cause a greater change on reducing risk and also improves the performance of financial institution in Nigeria. The study therefore, concludes that investment diversification will improve the performance of banking institutions in Nigeria. Furthermore Losses in one sector or location can be compensated from the gain(s) obtained from other sector or location and therefore reduces the risk involve in investing in a very risky asset.

5.2 Recommendations

In line with the above findings, the following policy recommendations are proposed

- i. Banking institutions should take into consideration the strategic decisions of risk and return preferences before diversifying.
- ii. The management of banking institutions should be prudent in the management of diversification strategy due to the fact that it enhances the well-being of a business and also on the other hand, if the diversification level increases, it could lead to rising of costs and diversification may not be associated with higher returns in these circumstances.

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Appendix
Tables on Financial Performance of a Cross Section of Financial Institutions

Table 1:UBA Financials

Year	Bank	Return on equity	La	IS	IP	ISB
2009	UBA	0.07	606616000	188407000	269000	37753000
2010	UBA	0.02	596497	446408000	10843000	56695000
2011	UBA	0.1	689625000	529975000	10356000	61015000
2012	UBA	0.23	658922000	680817000	1770000	66727000
2013	UBA	0.18	937620000	811206000	2977000	65767000

Source: Bank Financial Statements, 2009 - 2013.

Table 2: Access Bank Financials

YEAR	Bank	Return on Equity	LA	IS	IP	ISB
2009	Access Bank	0.12	383778168	75057381	1404000	23299346
2010	Access Bank	0.07	429782319	119665960	12943078	24261123
2011	Access Bank	0.07	552401605	540477013	16097044	80400287
2012	Access Bank	0.15	604073399	447281811	14360567	43209688
2013	Access Bank	0.11	786169704	353811348	23974789	38029992

Source: Bank Financial Statements, 2009 - 2013.

Table 3: First Bank Financials

YEAR	Bank	Return on Equity	LA	IS	IP	ISB
2009	First Bank	0.27	1127900000	337181000	10326000	5503000
2010	First Bank	0.21	1127900000	337181000	10326000	5503000
2011	First Bank	0.25	1235615000	572853000	10708000	1000000
2012	First Bank	0.28	1235615000	572853000	10708000	1000000
2013	First Bank	0.23	937620000	811206000	2977000	65767000

Source: Bank Financial Statements, 2009 - 2013.

Table 4: Diamond Bank Financials

YEAR	Bank	Return on Equity	LA	IS	IP	ISB
2009	Diamond Bank	0.06	302486935	68776995	3474612	16442980
2010	Diamond Bank	0.06	294227900	73491632	3755064	17442980
2011	Diamond Bank	0.23	339266926	339266926	3833335	7865622
2012	Diamond Bank	0.22	339266926	339266926	3833335	7865622
2013	Diamond Bank	0.22	339266926	339266926	3833335	7865622

Source: Bank Financial Statements, 2009 - 2013.

Table 5: Eco Bank Financials

Year	Bank	Return on Equity	LA	IS	IP	ISB
2009	Eco Bank	0.06	183719000	15387000	29971000	2846000
2010	Eco Bank	0.06	231108000	19656000	19440000	2846000
2011	Eco Bank	0.23	401807000	347476000	67131000	2846000
2012	Eco Bank	0.22	546873000	81366000	59387000	2846000
2013	Eco Bank	0.22	625907000	57555000	56134000	2846000

Source: Bank Financial Statements, 2009 - 2013.

Keys:

LA= Loans & Advances to customer,

IS= Investment Securities,

IP= Investment Property and

ISB= Investment in Subsidiaries.