EFFECT OF EXCHANGE RATE WINDFALL ON THE PERFORMANCE OF DEPOSIT MONEY BANKS IN NIGERIA

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Abstract

The study examined exchange rate windfall and performance of deposit money in Nigeria. Ex post facto research design was adopted by the study. Ordinary least square regression was employed to analyze the data. It was found that exchange rate gains has positive and significant effect on the performance of deposit money banks, exchange rate premium has positive and significant effect on performance of deposit money bank and parallel market foreign exchange rate has positive and significant effect on deposit money bank in Nigeria. The study concluded that windfalls in foreign exchange transactions have positive and significant effect on deposit money banks in Nigeria. The study recommended that Banks shouldimplement a coordinated scheme that will boost exchange rate gains; this will further expand the income accruing to the bank from such foreign exchange denominated transactions and boost the banks financial performance, banks should expand their other operations in the foreign exchange market that generate higher premium, this will increase the contribution of the exchange rate premium on their income base and profitability and there should be leverage on the growing size of banks' participation in the foreign exchange market to further boost their financial performance

Key words: Exchange Rate, Deposit Money Bank and exchange rate windfall

Introduction

In a bid to harmonize the exchange rate,within the landscape of Nigeria economy by the Central Bank of Nigeria (CBN), there has beena significant devaluation of the Naira.This monetary policy shift has had a profound impact on the financial sector, particularly on banks, which have experienced a windfall due to their foreign currency holdings. Banks in Nigeria experience exchange rate windfall when the value of their foreign currency reserves increases relative to the Naira. This can happen when the government liberalizes the exchange rate, which can lead to substantial revaluation gains on a bank's foreign exchange holdings.

Nigerian leading commercial banks recorded significant foreign exchange revaluation gains estimated at a combined gain of about N1. 7 trillion in the first half of 2023, a significant increase compared to a combined gain of N66.559 billion in 2022. In the first nine months of 2023, nine commercial banks saw their profits before tax rise by 156.4% to N2.3 trillion, with 63.6% of that profit coming from foreign exchange-related transactions. Commercial banks earned as much as N2.4 trillion in 2023 and other N883 billion in the first quarter of 2024.The banks include Access Holdings, FCMB, Fidelity, GTCO, Stanbic IBTC, UBA, and Zenith Bank. GTCO recorded the highest forex gain among Nigerian banks, totaling N844.450 billion for the 2023 financial year and the first quarter of 2024. The banks are projected to make a total of about ₦4.4 trillion in profits in 2023 and another ₦2.03 trillion in the first quarter of 2024. This imply that the banks performance (in terms of annual total profits before tax) could be impact, reaching about or exceeding ₦8.2 trillion in 2024 (Nairalytics, 2024).

The forex gains earned by commercial banks are as a result of the massive devaluation of the naira, which occurred when the central bank unified the exchange rate markets.The forex unification meant Nigerian banks with significant forex assets registered massive profits on paper, leading to some of the largest profits ever declared by the financial services sector. In addition to banks, the oil and gas sectors and businesses with significant dollar earnings also gained massively from the forex devaluation. But in contrast, manufacturing companies and other major sub-sectors of the economy faced severe challenges. The cost of imported raw materials and equipment surged due to the weaker naira, squeezing profit margins and escalating production costs.

The fluctuations in the official foreign exchange rate and the parallel market exchange rate are what oiled the windfall gains made by banks. The official rate had fluctuated due to series of devaluation policy of the CBN, the parallel market rate maintain almost daily fluctuation, often rising more than 50% daily. The sharp rise in the parallel market rates created very large exchange rate premium (the differential between the official exchange rate and the parallel market exchange rate). In 2012, the official exchange rate was N157.50 to $1 which part of the themes for the January 2012 protests; by 2015 during the electioneering period it rose about 28% to N193.28/$. In 2016 when the economic was in recession, the official exchange rate was N253.49/$, N306.92/$ in 2019 and N645.19/$ in 2023 (CBN, 2023). These rises followed series of devaluation policies.It rose more than 40% to N931.28/$ in 2019 and currently hovers at N1657.28/$ in 2024 These created very wide margins between the official and market rates (premium) which have been instrumental to the eruptions in the substantial exchange rate gains (windfall) made by banks.

In relation to the banks' performance, these windfall earnings from exchange rate transactions indicate strong financial performance with immediate positive impacts on cash flow, earnings stability, and investor confidence on the banks as their profitability growth has continued to impress. The banks' extensive international operations and effective currency management strategies have positioned it to benefit from forex market fluctuations. While the bank attributed its earnings and profitability growth to significant increases in interest and non-interest income, the results also reflect substantial contributions from forex gains. This significant gain greatly contributed to the bank's profitability during these periods, and while these forex gains have significantly boosted the banks' bottom lines, some of the banks attribute their growth to robust earnings from both interest and non-interest income.

Statement of the Problem

Many companies struggled to maintain their operations, leading to reduced output, layoffs, and in some cases, closure of businesses unable to cope with the new financial realities (KPMG, 2024). The major impact of the losses was felt in their external loans, which upon forex depreciation forced them to incur significant forex losses. Though most of these losses were unrealized initially, they were eventually realized, putting further strain on their financial stability.Consumers, too, felt the impact as prices of goods and services soared, reducing purchasing power and increasing the cost of living.The devaluation, while beneficial for some sectors, suggests a deeper economic divide and highlighted the vulnerabilities of an economy heavily reliant on imports for its manufacturing and consumption needs.

For the banks, despite the huge windfall from exchange rate transactions, fluctuation in the exchange rate have affected them in several ways, including Reduced profitability, Increased credit risk, Difficulty predicting future exchange rates, as well as Increased bad loans.It is on this premise that the study examined effect of exchange rate windfall on the performance of deposit money banks in Nigeria

Objectives of the Study

The broad objective of this study was to examine the impact of exchange rate windfall on performance of selected deposit money banks in Nigeria. The specific objectives were:

1. To determine the impact of exchange rate gains on performance of selected deposit money banks in Nigeria
2. To examine the impact of exchange rate premium on the performance of selected depositm o n e y banks in Nigeria
3. To evaluate the impact if parallel market exchange rate on the performance of selected deposit money banks in Nigeria

Hypotheses of the Study

The following hypotheses were formulated in null forms and tested

HO_1: exchange rate gains has no impact on the performance of selected deposit money banks in Nigeria

HO_2: there is no significant impact of exchange rate premium on the performance of selected deposit money banks in Nigeria

HO_3: parallel market exchange rate has no significant impact on the performance of selected deposit money banks in Nigeria

Conceptualization of Concepts

Exchange Rate Windfall

Windfall is an unexpected and substantial financial gains experienced by a firm especially banks from certain transactions. "Exchange rate windfall is a foreign exchange gain which occurs when a banks buy and/or sell products and services in a foreign currency (the Dollar), and the currency fluctuates relative to the home currency (the naira). It the fluctuation of the Dollar relative to the naira creates differences in value in the monetary assets and liabilities of the banks. An exchange rate windfall in Nigeria is a significant profit made by banks from foreign exchange transactions" (Osho and Fagbamila, 2022). Owolabi and Babalola (2023) defined exchange rate windfall as a massive profit gained by banks and related financial services providers as a result of depreciation in the value of the Naira and appreciation of the U.S. Dollar due to the devaluation policy of government.

Exchange Rate Gain

Exchange rate gain is defined as a profit that occurs when a company sells goods or services in a foreign currency and the foreign currency increases in value relative to the company's home currency. Given that exchange rate is the value of one currency relative to another, exchange rates change over time due to economic and political factors. When a firm buys or sells goods in a foreign currency, the value of the transaction can change if the exchange rate changes. If the firm sells the goods at a higher rate than when they were originally recorded, the firm has made an exchange rate gain. The gain is recorded on the firm's income statement. Exchange rate gain occurs mainly when the value of one currency increases relative to another after the conversion (the Dollar-Naira rate in this instance), and also when the transaction is settled at a higher rate than when it was recorded. Foreign exchange gain/loss occurs when a company buys and/or sells goods and services in a foreign currency, and that currency fluctuates relative to their home currency. It can create differences in value in the monetary assets and liabilities, which must be recognized periodically until they are ultimately settled.

Exchange Rate Premium

According to Owolabi and Babalola (2023), exchange rate premium is defined as the "difference between the spot price and the forward or futures price of a currency. It can also refer to the total cost of an option. Exchange rate is the rate at which one currency is exchanged for another, the spot price is the price of a currency at a given time, and the forward price is the price of a currency at a future time, while an option is a financial instrument that derives its value from the market valuation of an underlying asset. Exchange rate premiums can be associated with domestic currency overvaluation. This can have negative economic consequences, such as: reduced growth, contraction of the tradable goods sector, worsened balance of trade, increased inflation, and reduced export revenue"

Parallel Market Exchange Rate

The parallel foreign exchange rate is defined as the rate that is determined by market forces in an informal market different from the formal autonomous market (Oluremi, 2015). Parallel foreign exchange market known as, black market can be defined as the market for diversion of foreign currencies through the unofficial market or illegal market which affect the official foreign exchange market activities (Nwogo, 2017). An increase in the demand for foreign exchange with a shrinking supply line encouraged the development of a flourishing parallel "black" market for foreign exchange.

Literature Review

Owolabi and Olukilede (2024) "studied the effect of foreign exchange rates on the profitability of Nigerian banks between 2013 and 2022 (using First Bank Plc's Lagos and Ondo branches as a case study). Using the Taro-Yamane formula, 146 samples were chosen from the target population of 250 populations. The findings of the study indicated that foreign exchange rate has a major impact on banks' profits. They recommended that the government should take appropriate steps to protect the value of the national currency by encouraging foreign direct investment. This would lead to economic growth and the appreciation of the local currency, which will make the currency more stable."

Akinyemi, Ogboada and Bala (2022) examined the empirical effect and future dynamic interactions, of exchange volatility on the corporate performance of deposit money banks in Nigeria using a timeseries data set of Nigeria global bank, as a sample focus over the period 1986-2021. The study employed impulse response function generated from the estimated vector error correction model (VECM). The empirical findings of the study suggested that exchange rate has statistically significant negative impact on the banks profitability variables included as control variables in the vector auto regression (VAR) analysis, total deposits (TDPO) and gross domestic products (GDP) growth are found to have significant positive impact on bank profitability and bank size in Nigeria. The study recommended that bank managers and governing body should focus on the composition effect of exchange rate variation on deposit money banks' profitability and size and make sure to availappropriate strategy to reduce it adverse effect on the profitability of their bank.

Ibekwe, Angela, and Obiageli (2021) "examined the impact of exchange rate on the deposit money banks' performance in Nigeria. Time series data that was already available in reports and financial publications on a variety of issues was used in the study. The figures, together with the Nigeria Deposit Insurance Corporation's annual report, were released by the Central Bank of Nigeria and the National Bureau of Statistics (N.B.S). Based on the analysis, there is a strong correlation between the exchange rate and the performance of commercial banks in Nigeria. The research concludes that improving exchange rate fluctuations, nominal exchange rate, real exchange rate, and placing particular emphasis on these areas will help boost investment in Nigeria and financial performance metrics".

Anyanwu, Anawude, and Okoye (2017) conducted study on Nigeria's economic growth from 1986 to 2015 and the exchange rate policy. Real gross domestic product and manufacturing capacity utilization (MCU) were proxied by the dependent variable, whereas real exchange rate (REXR), inflation, and interest rate were proxied by the independent variable, exchange rates. The 2015 Central Bank of Nigeria Statistical Bulletin was used as a source of secondary data. The ordinary least square estimate methodology (OLS) and co-integration approach were the methods used in this investigation. The study discovered that during the study period, there was a considerable impact on real exchange rates and manufacturing capacity utilization.

Takon, Nsofor, and Ugwuegbe (2016) investigated the impact of foreign exchange rates on the profitability of Nigerian banks and discovered that foreign exchange income had a negative effect over the studied period. According to the study's findings, Nigerian banks can maintain their profitability without relying on the premium from selling foreign exchange. The results of the study also demonstrated that banks' total assets had a positive impact on their profitability. Consequently, it was recommended that banks focus more on building a strong asset base rather than receiving lavish premiums from the sale of foreign exchange.

Carolyn and Daniel (2016) "researched on the effects of fluctuations in foreign exchange rates on the financial performance of commercial banks listed at the Nairobi Securities Currency between 2006 and 2013. They proxied financial performance and foreign currency proxied exchange rates are the independent and dependent variables, respectively. The data was analyzed to find the relationship between changes in inflation, interest rates, foreign currency rates, and bank performance indicators using multivariate linear regression and time series correlation. The Pearson product moment correlation (r) was used to determine the relationship between the variables. The study found a strong positive relationship between foreign exchange rates and financial performance measures".

Adeniran (2014) "empirically assessed how exchange rates affected the Nigerian economy. The study looked at the relationship between changes in Nigeria's GDP and economic variables including inflation and currency rates. The study used secondary data that was analysed using multiple regression using the Ordinary Least Squares (OLS) method. The secondary data came from the annual reports of the Nigeria Securities and Exchange Commission (SEC), the Nigerian Stock Exchange (NSE), and the Central Bank of Nigeria (CBN). The result showed that Nigeria's GDP and economic growth are significantly impacted by the two variables—the exchange rate and inflation rate. Exchange rates have a negative influence on GDP because they have a significant negative impact on economic growth, but inflation has a positive effect on GDP since firms are more likely to create when inflation is high and vice versa. The study concluded that the government should boost local production, advance infrastructure development, and reestablish property and life protection in order to lessen the pressure on the dollar and improve Nigeria's economic environment for investment. This would support an increase in the value of the naira, which would raise GDP".

According to research done in 2013 by Ani, Ngwunta, and Okanya, foreign exchange changes are not having the desired beneficial effect on the development of the Nigerian financial sector. They argue that financial liberalization has the potential to greatly boost economic growth. This indicates that the recommended exchange rate reforms—that is, maintaining a stable currency rate that can attract foreign investment or halt capital flight—have not resulted in the domestic economy doing excellently. In terms of value growth, Nigerian Naira has consistently underperformed other currencies on the international scene. Their studies frequently demonstrate that whereas improvements in the financial services sector led to significant short-term financial booms and busts, these events did not worsen over time. According to (Ani et al., 2013), the evidence from the non-spurious regression results revealed that Nigeria's foreign exchange reforms had not had the desired positive influence on the depth of the banking sector in the nation. It is asserted that financial liberalization significantly improves economic performance.

Theoretical Framework

The study is anchored on Purchasing Power Parity (PPP) theory. The theory was advanced by Menon and Viswanathan (2005). "It states that the value of homogenous goods is similar in different countries based on the currency of each country. According to them, when purchasing power is similar in different countries then the exchange rates between the country's currencies will be at equilibrium." According Ross (2008), a country's currency may be incorrectly valued whereby money has no purchasing power against the country's commodities level. The basic assumptions of this theory are that there are no transactional costs, no barriers to trade and the commodities being traded are homogeneous. If the trading currency is exchanged at the spot exchange rate, the price of a homogenous commodity should be identical across borders. The theory suggested use of price indexes to determine the exact price of a homogenous commodity between countries.

The major setback of this theory as pointed out by (Reid, 2005) is in measuring Purchasing Power Parity constructed from price indexes given that different countries use different goods to determine their price level. This theory is relevant for this study as it explains a country's currency value over another country's currency. This theory argues that in the equilibrium exchange rate is one that ensures that the value exchanged can purchase the same basket of goods and services from either of the countries involved.

Methodology

The study adopted the *ex post facto* research design because the study is basically on secondary source data. This design enabled the study to estimate the coefficients of the independent variables. The data used for this study were sourced from the Nigeria Bureau of Statistics and the CBN statistical bulletin of 2023.

Model Specification

In order to obtain the coefficient of the effect of exchange rate windfall variables, the following model was specified for the study. The model followed the general formula for regression analysis. The model by Owolabi et al (2023) was adopted and modified for this study. Thus, the functional model was specified as:

ROA = (EXRG, EXP, PMER)

Based on panel econometric procedure, the model is transformed as:

$ROA_{it} = \beta 0 + \beta_1 EXRG_{it} + \beta_2 EXP_{it} + \beta_1 PMER_{it} + Ut_{it}$

Where

ROA = return on asset

EXRG = Exchange rate gain

EXP = Exchange rate premium

PMER = Parallel market exchange rate

β0 = constant term

β1, β2 and β3 are the coefficients of the independent variables.

it = the cross-sectional and time effects of the independent variables

Analytical Technique and Decision Rule

The study used the ordinary least squares (OLS) regression technique to analyze the data and estimate the coefficients of the model variables.

The decision rule for the test of hypothesis is stated as follows:

Decision rule one: reject the null hypothesis if the p-value is less than 0.05, or the t-statistic greater than or equal to 2.0

Decision rule two: accept the null hypothesis if the p-value is greater than 0.05 or the t-statistics less than

RESULTS

Descriptive Test

The study conducted the selected descriptive tests to check for normality of the data. The tests include the mean, standard deviation and the skewness. The result is presented below:

Table 1: Descriptive result

	ROA	EXRG	EXP	PMER
Mean	0.026334	20.56125	26.28513	28.34225
Std. Dev.	0.007619	8.273597	39.41684	47.68686
Skewness	0.761240	0.999432	0.895034	0.915943
Observations	12	12	12	12

Source: Researchers' computation 2024

From the descriptive result as presented above, the study found that the mean value of the return on assets during the period (2012-2023) was average of 2.63% annually. The exchange rate gain (EXRG), exchange rate premium (EXP) and the parallel market exchange rate (PMER) averaged 20.56%, 26.28% and 28.34% respectively.

On the deviation, the values were 0.007619, 8.273597, 39.41684 and 47.68686 for return on assets, exchange rate gain (EXRG), exchange rate premium (EXP) and the parallel market exchange rate (PMER) respectively. This means that the data are from normally distributed sample, therefore suitable for this analysis. Data which show wide deviations makes forecasting and policy streaming difficult as the generalizations that come from such series do not often show true reflection of the general population

Correlation Test

To check the relationship that exists among the variables, the study used correlation test and the result is presented below:

Table 2: Correlation test result

	ROA	EXRG	EXP	PMER
ROA	1.000000			
EXRG	0.535768	1.000000		
EXP	0.575411	0.996371	1.000000	
PMER	0.568643	0.997528	0.999889	1.000000

Source: Researchers' computation 2024

The correlation result is presented in diagonal form to show both the nature of association between the dependent variable (return on asset) and the independent variables (exchange rate windfall); and among the independent variables themselves. The result as presented above show that during the period, all the exchange rate windfall variables had positive relationship with the performance of the deposit money banks (return on asset).

Regression

The ordinary least square regression was used to investigate the effect of exchange rate windfall on the financial performance of selected deposit money banks, and to extract the coefficient of the independent variables. The result is presented below:

Table 3: Regression result

Dependent Variable: ROA

Method: Least Squares

Date: 13/12/24 Time: 16:43

Sample: 2012 2023

Included observations: 12

Variable	Coefficient	Std. Error	t-Statistic	Prob.
EXRG	2.466547	0.133364	3.498307	0.0003
EXP	0.464721	0.132811	3.499123	0.0173
PMER	1.464744	0.132846	3.498363	0.0013

R-squared	0.805065	Mean dependent var	0.026334
Adjusted R-squared	0.727092	S.D. dependent var	0.007619
S.E. of regression	0.003980	Akaike info criterion	-7.935088
Sum squared resid	7.920205	Schwarz criterion	-7.905297
Log likelihood	34.74035	Hannan-Quinn criter.	-8.136014
Durbin-Watson stat	2.651371		

Source: Researchers' computation 2024

According to the result, the coefficient of determination which shows the strength of the effect indicated that the variation in the bank's' performance (as proxy by the return on assets) due to the non-interest income of the bank is about 80.61%. The variable by variable analysis show that the all the exchange rate variables had positive effect on the bank performance during the period under study (2012-2023). The variation in the performance of the deposit money banks within the periodwas influenced by exchange rate windfall by about 80.51% as indicated by the coefficient of determination (R-squared). With a standard error of regression (0.003980), it was indicated that the overall regression was statistically significant.

Test of Hypotheses

Decision rule one: reject the null hypothesis if the p-value is less than 0.05, or the t-statistic greater than or equal to 2.0

Decision rule two: accept the null hypothesis if the p-value is greater than 0.05 or the t-statistics less than 2.0

Test of Hypothesis One

HO_1: exchange rate gains has no impact on the performance of selected deposit money banks in Nigeria

From the result in table 3.0 above, it showed that the p-value is 0.0003 while the t-statistic is 3.498307. Since the p-value is less than 0.05 and the t-stat greater than 2.0, the study rejected the null hypothesis and accepted the alternative. In conclusion, exchange rate gains have significant positive impact on the performance of deposit money banks in Nigeria.

Test of Hypothesis Two

HO_2: there is no significant impact of exchange rate premium on the performance of deposit money banks in Nigeria

From the result in table 3.0 above, it was observed that for the variable exchange rate premium (EXP), the p-value is 0.0173 while the t-statistic is 3.499123. Since the p-value is less than 0.05 and the t-stat greater than 2.0, the study rejected the null hypothesis and accepted the alternative. In conclusion, there is positive and significant impact of exchange rate premium on the performance of deposit money banks in Nigeria.

Test of Hypothesis Three

HO_3: parallel market exchange rate has no significant impact on the performance of deposit money banks in Nigeria

From the result in table 3.0 above, it was observed that for the variable total parallel market foreign exchange rate (PMER), the p-value is 0013 while the t-statistic is 3.498363. Based on the decision rule, since the p-value is less than 0.05 and the t-stat greater than 2.0, the study rejected the null hypothesis and accepted the alternative. The study concluded that parallel market exchange rate has positive and significant impact on the performance of deposit money banks in Nigeria.

Summary of Finding

This study investigated the effect of exchange rate windfall on the financial performance of deposit money banks in Nigeria. The study covered the period 2012-2023. The study reviewed the conceptual, theoretical and empirical literatures on the topic. The summary of the major findings are:

1. Exchange rate gains were found to have positive significant effect on the financial performance of deposit money banks in Nigeria [the p-value is 0.0003 while the t-statistic is 3.498307].
2. Exchange rate premium was found to have positive and significant effect on the financial performance of deposit money banks in Nigeria [the p-value is 0.0173 while the t-statistic is 3.499123]

3. The parallel market foreign exchange rate was found to have positive significant effect of on the financial performance of deposit money banks in Nigeria [p-value is 0.0013 while the t-statistic is 3.498363)

Conclusion

The study focused on investigating the effect of exchange rate windfalls on the financial performance of deposit money banks in Nigeria. Based on the results from the analytical tests carried out, the study concluded that windfalls in foreign exchange transactions have significant positive effect on the performance of deposit money banks (DMBs) in Nigeria.

Recommendations

Based on the findings, the study recommended the following:

1. Banks shouldimplement a coordinated scheme that will boost exchange rate gains; this will further expand the income accruing to the bank from such foreign exchange denominated transactions and boost the banks financial performance.
2. Banks should expand their other operations in the foreign exchange market that generate higher premium, this will increase the contribution of the exchange rate premium on their income base and profitability.
3. There should be leverage on the growing size of banks' participation in the foreign exchange market to further boost their financial performance

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