



MANAGEMENT DYNAMICS

A Peer-reviewed Journal of Management and Economics



Published by
Shanker Dev Campus
Tribhuvan University, Nepal

Liquidity and Profitability of Low and High Turnover Commercial Banks in Nepal

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Article Info

Received: 21 April 2021

Revised: 14 May 2021

Accepted: 18 May 2021

DOI: <https://doi.org/10.3126/md.v24i1.47543>

Keywords:

liquidity,
net profit ratio,
return on assets,
return on equity

ABSTRACT

This paper explores the effect of several bank-specific variables, including capital and liquidity, on the profitability of listed commercial banks operating in Nepal. Factors of banks' profitability like net profit ratio, return on assets, and return on equity have been assessed by the panel data (10 observations) of six listed banks out of twenty-seven banks. In this study, liquidity has been quantified in regulatory capital, loan and advance to total deposit, liquid assets to total assets, liquid assets to total deposit, and cash reserve ratio. This study found a significant correlation between liquidity variables and profitability variables. Again, it has been shown that the cash reserve ratio significantly impacts the net profit ratio, return on assets, and equity. Likewise, loan and advance to total deposit, liquid assets to total assets, and liquid assets to total deposit have no significant impact on the selected banks' net profit ratio, return on assets, and return on equity.

1. INTRODUCTION

Liquidity management is an essential tool for the management of banks. The operating expense, financial expenses, short-term liability, and long-term liability of commercial banks depend on liquidity. Liquidity is vital to the functioning of financial markets, particularly in the banking industry, because one of the most significant components of the banking business is converting short-term cash into medium- and long-term investments (Putri & Wiksuana,

2021). Profitability is a broad subject of study as its relation to performance is of great concern in the construction of all other industries, including banking. It can be determined in terms of return on assets (ROA), return on equity (ROE), return on capital employed (ROCE), and net interest margin (NIM) (Mishra, Kandel, & Aithal, 2021). Liquidity and profitability play a significant role in the financial sectors, and liquidity is the primary factor in meeting customers' obligations. Since Liquidity and Profitability hold a vital relationship for the organization, the organization needs to keep ample liquidity to maximize its Profitability (Khan & Raj, 2020). Profitability is the primary goal of the business for survival and growth. Banks need short-term funds rather than external debts to generate more profit. Liquidity tells about the business's capability to meet the short-term need for funds by banks, and profitability talks about the profit generated from the operation of banks (Gardy, Hamawandy, & Sulaiman, 2020).

Nepal Rastra Bank employed open market operations to regulate liquidity effectively. Because liquid assets such as cash and government securities provide poor returns, a bank incurs an opportunity cost by storing them. In the absence of regulation, it's reasonable to assume that banks will maintain liquid assets to the extent that they enable the firm to maximize its profits. Upholding proper liquidity indicates that funds are limited to liquid assets, making them unavailable for short-term/operational use and for generating higher returns for investment purposes.

An opportunity cost is associated with the maintenance of those liquid assets, which might affect the firm's overall profitability. In other words, increasing profitability would tend to reduce the firm's liquidity and too much attention to liquidity would affect profitability. Therefore, firms should always strike to balance conflicting objectives of Liquidity and Profitability.

Pangeni (2016) found that the relationship between the Profitability and Liquidity of the big Commercial Banks only has the highest capital and earned the highest interest. Pradhan and Gajurel (2016) focused that the impact of Liquidity on Commercial Banks in Nepal was also on the Banks having huge capital. No research has been undertaken regarding the comparative analysis of Low turnover and High Turnover Commercial Banks in Nepal. Macharia (2013) found a strong and positive relationship between Liquidity and Profitability. But Molyneux and Thornton (1992) established a negative relationship between Liquidity and Profitability. Liquidity might be your emergency savings account or the cash lying with you that you can access in case of any unforeseen event or financial setback (The Economic Times, 2021). Any firm is not likely to hold high liquidity because a high level of liquidity is undesirable. After all, idle assets generate nothing. The firm's fund will be entangled with present assets unnecessarily. A high level of liquidity is likewise undesirable because idle assets generate nothing. The firm's fund will be entangled with present assets unnecessarily. Therefore, it is necessary to strike a proper balance between high liquidity and lack of Liquidity (The Himalayan Times, 2018).

Liquidity measures the extent to which a person or organization has the cash to meet immediate and short-term obligations or assets that can be quickly converted. Liquidity can further be termed as a bank's capacity to fund an increase in assets and reasonably meet expected and unexpected cash and collateral obligations without incurring unacceptable losses. Liquidity defines the spare capital that is available for investment. The majority of this capital is now in credit rather than cash. The ability of a bank to maintain sufficient funds to pay for its maturing commitments is referred to as bank liquidity. It refers to a bank's ability to meet immediate cash, check, and other withdrawal demands, as well as reasonable new loan demand, while remaining compliant with existing reserve standards (BAFIA Act, (2017)

People deposit savings into a bank to safeguard them, earn interest, and get back whenever needed. Therefore, banks must maintain liquidity to refund deposits when account holders withdraw deposits. Hence, liquidity is the life-blood of a bank, without which a bank cannot survive for long. Banking transactions are heavily dependent upon the mutual faith between bankers and customers. It is essential to maintain sufficient cash reserve in the bank to maintain the public faith (Baral, 2020).

Profitability is also an important factor in measuring liquidity – more the profit, the liquidity in the organization (Ibrahim, 2017). The profitability ratios are calculated to measure the operating efficiency of the company. Besides the company's management, creditors and owners are also interested in the firm's profitability. Creditors want to get curious and repay of principal regularly. Owners want to get the required rate of return on their investment. It is possible only when the company earns enough profits (Pangeni 2016). Pimentel et al. (2005) defined profitability as a measure of efficiency, and the search for it provides an incentive to achieve efficiency. Profitability also indicates public acceptance of the product and shows that the firm can produce competitively. Moreover, profits provide the money for repaying the debt incurred to finance the project and the resources for the internal financing expansion.

Return on assets is the ratio that measures the firm's ability to use its assets to create profits. The net income is the amount of the firm's income that is available for distribution to the firm's shareholders. Average assets are the average of assets at the start and end of the firm's financial year used to generate the income. Return on assets is useful for comparing competing companies in the same industry. The number will vary widely across different industries. Return on assets indicates the company's capital intensity, which will depend on the industry; companies that require large initial investments will generally have a lower return on assets (Magni, 2015).

Abebayo, David, and Samuel (2011) concluded that Liquidity and Profitability have a significant relationship. That means profitability in commercial banks is significantly influenced by liquidity and vice versa. In this study, it can be concluded that the profit of the stated Commercial Banks within the selected time frame is below optimum because of the high liquidity maintained. For the success of operations and survival, commercial banks should not compromise efficient and effective liquidity management. They are expected

to maintain optimal liquidity levels to satisfy their financial obligations to customers or depositors and maximize profits for the shareholders. Jonattan and XU (2011) revealed the relationship between liquidity risk and the performance of 12 commercial banks in the Eurozone from 2005 to 2010. Descriptive statistics were performed to explain each bank's behavioural pattern of liquidity position and performance ratios. 35 Independent Variable Liquidity Ratio Dependent Variable Profitability Ratio Net Profit Ratio Return on Assets Return on Equity Further inferential analysis was done to know the relationship between Liquidity and Profitability. Results of the study disclose a mixed effect relationship with some ratios positively related to liquidity risk indicators while others display a negative relationship. Based on this mixed effect relationship, it cannot be firmly concluded that a relationship exists between liquidity risk indicators and bank performance measures.

Lartey, Antwi, and Boady (2013) found the positive and weak relationship between the Liquidity and Profitability of the listed banks. Descriptive statistics were performed to explain each bank's behavioural pattern of liquidity position and performance ratios. The inferential analysis described the impact of liquidity on the profitability of the selected banks. The selected banks were increasing their liquid assets, but the listed banks' profitability was not increasing. Even though there is a positive relationship between Liquidity and Profitability. The Coefficient of Determination between Profitability and Liquidity was 0.056, which means that an increase in liquidity could cause only a 5.6% increase in profitability. Slaw (2013) examined the factors of liquidity risk of Ghanaian banks and how it affects their profitability. Hausman test was used to estimate the factors of bank liquidity risk with data set of 22 banks over ten years. The two-stage least squares approach was applied to estimate the effects of liquidity risk on bank profitability due to the endogenous nature of liquidity risk as a bank profitability determinant while controlling for other variables (bank size, capital adequacy, credit risk, operational expenditure, non-interest income, industry concentration and change in gross domestic product). To check for the robustness of the results, the ratio of net loans to total deposits as an alternative measure for liquidity risk was also applied. The results showed consistency with the results obtained from using the financing gap ratio as a measure of liquidity risk. Again, the results from the use of instrumental variables for liquidity risk while controlling for other variables (factors) also show a positive relationship between liquidity risk (both the financing gap ratio and the ratio of net loans to total deposits and bank profitability measured by the return on assets (ROA) and the return on equity (ROE).

Macharia (2013) studied the relationship between Profitability and Liquidity and found a positive relationship between Profitability and Liquidity. There was a positive relationship between ROA, current ratio, and liquid ratio. This study concluded that Profitability and Liquidity have a positive relationship and that liquidity is one of the factors of profitability of commercial banks. However, from the study results, liquidity is not a significant determinant of commercial banks' profitability but one of its determinants. Alshatti (2015) disclosed that an increase in the quick ratio and the investment ratio of the available funds leads to an increase in the profitability, while an increase in the capital ratio and the liquid assets ratio leads to a decrease in the profitability of the Jordanian commercial banks. The researcher recommends

a need for optimum utilization of the available liquidity in various aspects of investment to increase the banks' profitability. Banks should adopt a general liquidity management framework to ensure sufficient liquidity for executing their operations more efficiently. Pangeni (2016) examined the positive relationship between Liquidity and Profitability. The liquidity held by the sample banks led the banks to increase their net profit margin and return on equity. However, if liquid assets are held excessively, profitability could diminish. Liquid assets usually have no or little interest in generating capacity. The opportunity cost of holding low-return assets would eventually outweigh the benefit of any increase in the bank's liquidity resiliency as perceived by funding markets.

Bassey et al. (2016) investigated the relationship between the variables of bank performance and liquidity management using bank deposit, cash reserve requirement, bank investment, and cash ratio as indicators in Nigeria. Data were analyzed using simple percentages and a simple regression model. The results indicated a strong relationship between bank deposit and bank reserve requirement and bank investment and cash ratio. Sunday and Ndukaife (2016) found a negative and significant relationship between liquidity ratio and deposit money bank's profitability. There is a positive and significant relationship between the cash to deposit ratio and the profitability of the deposit money banks in Nigeria. In line with these findings, it is recommended that instead of keeping excessive liquidity as a provision for unexpected deposit withdrawals from the customers, the deposit money banks should find it reasonable to adopt other measures of meeting such requirements, which can include borrowing and discounting bills and also that there is a need to invest the excess of liquidity available at in available investments with various degrees of liquidity to increase the banks' profitability and to get benefits from the time value of the available money. Patel and Sharma (2017) found that weak and positive relationship between Liquidity and Profitability in public sector enterprises in Gujarat. The relation is measured with the help of various financial ratios, i.e., current ratio, quick ratio, working capital ratio, return on capital employed, and debt-equity ratio. The study recommends that companies focus on liquidity management, which positively affects the company's profitability.

Al-Qadi and Khanji (2018) examined the relationship between Liquidity and Profitability through more than one liquidity indicator. Liquidity indicators include the current ratio and quick ratio, which measure the company's ability to meet its short-term obligations, while ROA and ROE measure profitability. The study revealed a significant impact of the independent variable quick ratio on the dependent variable return on asset (ROA). That means profitability through return on assets (ROA) is significantly influenced by liquidity through current and quick ratios. Owolabi, Obiakor, and Okwu (2018) examined the relationship between Liquidity and Profitability in 15 selected quoted companies in Nigeria. The liquidity measure is the current assets- liabilities ratio, while the profitability measure is the operating profit- turnover ratio. Investigative and quantitative analysis methods were used for the study. Correlation and regression analysis were employed to examine the nature and extent of the relationship between the variables and determine whether there was any cause-and-effect relationship between them. The results showed that while a trade-off existed

between Liquidity and Profitability in the banking industry, the two variables were positively correlated and reinforced each other in the other companies.

Kryeziu (2019) explored that liquidity has a significant effect on the profitability levels of commercial banks. The study noted that banks' liquidity was one of the major elements of Kenyan banks' profitability. It is because adequate liquidity helps to minimize liquidity and financial crises of the banks. The effect on profitability is higher when the liquid assets are not held exclusively because exclusive liquid assets have no or little interest-generating capacity. Also, the opportunity cost of holding low-return assets would eventually outweigh the benefit of any increase in the banks' liquidity resiliency as perceived by funding markets. Baral (2020) opined that lack of adequate liquidity is often one of the first signs that a bank is serious about financial trouble. The bank should have adequate liquidity to minimize both asset side liquidity risk and liability side liquidity risk of a commercial bank. Both liquidity deficit and much more liquidity surplus indicate the problem in the financial health of a commercial bank. Liquidity indicators of Commercial Banks show that they have stored a high level of liquidity and are not facing the liquidity deficit problem. Instead, they are facing a high liquidity problem. Their high liquidity is affecting their financial health adversely by deteriorating their profitability. Thus, from the viewpoint of liquidity position, the health of Commercial Banks is looked a little bit unhealthy. Neupane (2020) found a mixed relationship between Liquidity and Profitability. To measure liquidity, current assets, current liabilities, and current ratio are used, and profitability sales revenue, net profit, and net profit are used. This research indicates that sales have a perfect positive relationship but have a negative relationship between networking capital and profitability. The results suggested that if the firm can manage the working capital in cash, accounts receivable, and inventories properly, it will ultimately increase the profit.

Paul, Bhowmik, and Famanna (2020) examined the impact of Liquidity and Profitability on the Commercial Banks in Bangladesh. Liquidity is used as an independent variable, and profitability is used as a dependent variable loan to deposit ratio, deposit assets ratio, call deposit receipt, and loan to asset ratio. The current ratio represents liquidity, whereas the return on equity represents profitability. It was concluded that loan to deposit ratio, deposit asset ratio, and call deposit receipt had a substantial effect on return on equity, which means an increase in the stated independent variable would increase the profitability and vice versa. In contrast, the loan to asset ratio and current ratio shows an insignificant relationship with return on equity. So, the researchers concluded that liquidity has a significant effect on profitability in the commercial banking sector in Bangladesh. This research signifies that Bangladeshi bank will be best positioned if the equality between liquidity and profitability is maintained. Adhikari (2021) revealed the negative relationship between Liquidity and Profitability. The liquidity indicators positively and negatively impacted net profit margin, stock price, and earnings per share, but the impacts were statistically insignificant, and the overall model was also insignificant. This study concluded that the higher the profitability, the lesser the income, and vice versa.

Chaudhary (2021) concluded that the liquidity status of the bank plays an important role in banking performance in the case of Nepalese commercial banks. It is recommended that the finance managers pay attention to commercial banks' liquidity as one of the determinants of profitability. Profitability and liquidity reinforce each other, and therefore finance managers should not consider the two variables as an independent. In the light of the growing competition in the banking sector, the Himalayan Bank and Everest Bank. Mishra, Kandel, and Aithal (2021) examined the relationship between Liquidity and Profitability. The correlation, regression, and ratio analysis have been used to assure an association between return on assets (ROA), return on equity (ROE), and net interest margin (NIM). The research concludes that the size of banks is on an increasing trend. The standard deviation decreases, showing that Nepalese commercial bank has less utilized their assets as the year passes. The research shows the mixed relationship between Liquidity and Profitability. There is a negative relation between ROA and ROE with loan ratio, deposit ratio, and capital ratio, while a positive relationship exists between bank size and inflation. However, in the case of NIM, bank size, loan ratio, deposit ratio, and inflation exhibit a positive relationship, while the capital ratio shows a negative relationship with NIM.

This research has been carried out to identify the actual relationship between Liquidity and Profitability of Commercial banks in Nepal. The main objective of this study is to analyze the relationship between the Liquidity and Profitability of low turnover and high turnover of selected Commercial Banks in Nepal. The following hypotheses are developed for the study.

- H1: There is a significant relationship between liquidity variables and profitability variables.
- H2: There is a significant impact of LATD, LATA, LAT, and CRR on NPR.
- H3: There is a significant effect of LATD, LATA, LAT, and CRR on ROA.
- H4: There is a significant influence of LATD, LATA, LAT, and CRR on ROE.

2. METHODOLOGY

The study aims to answer, "Is there a significant relationship between liquidity variables and profitability variables, and is there a significant impact of liquidity variables on profitability variables? It describes, to significant users, how hypotheses were tested and the basis for which conclusions were drawn. This research work borders on the association of loan and advance to total deposit (LATD), liquid assets to total assets (LATA), liquid assets to total assets (LAT) with net profit ratio (NPR), return on assets (ROA) and return on equity (ROE) of NABIL, RBBL, ADBL, CBL, CCBL and CZBIL in Nepal. This study has used correlational and causal research design to test the study's objective. It relies on discretionary data collected from yearly reports of picked banks. Nabil Bank Limited (NABIL), Rashtriya Banijya Bank Ltd. (RBBL), Global IME Bank Ltd (GIMEBL), Civil Bank Ltd CBL), Citizens International Bank Ltd. (CIBL), and Century Commercial Bank Ltd. (CCBL). The banks have been chosen as a purposive technique out of twenty-seven commercial banks in Nepal. The study has used seven years of data for analysis.

3. RESULTS AND DISCUSSION

Correlation Analysis between variables was studied to find relations among them. Pearson's correlations analysis was carried out for variables. The correlation matrix was computed to assess the extent or degree of relationship between the research variables. A positive correlation reveals that the direction of the relation of the relationship is positive, with one increasing in reaction to the other's increase. Meanwhile, a negative correlation reveals an inverse of the above; an increase in one when the other decreases.

Table 1
Correlation Analysis

	LATD	LATA	LAT	CRR	NPR	ROA	ROE
LATD	1						
LATA	0.902**	1					
LAT	0.940**	0.718*	1				
CRR	0.522	0.705*	0.251	1			
NPR	0.761**	0.714*	0.725*	0.084	1		
ROA	0.661*	0.505	0.708*	-0.134	0.947**	1	
ROE	0.801**	0.820**	0.730*	0.205	0.967**	0.844**	1

** . Correlation is significant at the 0.01 level (2-tailed)

* . Correlation is significant at the 0.05 level (2-tailed)

Table 1 presents the correlation between the dependent variable and the independent variable. Correlation analysis used the 2-tailed test to infer the significance of the correlation between the dependent variable, i.e., NPR, ROA, and ROE, with the independent variables, i.e., LATD, LATA, LAT, CRR. The correlation between LATD and NPR is 0.761, which shows a significant strong positive relationship between LATD and NPR. The correlation between LATD and ROA is 0.661, which offers a strong positive relationship, and the relationship is also significant. Consequently, the correlation between LATD and ROE is .801. This shows the positive and significant relationship between the variables. So, it can be said that the independent variable LATD has a strong positive relationship with all dependent variables.

Similarly, the correlation between LATA and NPR is 0.714, which shows a strong positive relationship and a significant relationship. LATA and ROA have a moderate correlation of .505, which does not have a significant relationship with ROA. LATA has a strong positive relationship with ROE with 0.820 and a significant relationship with ROE. So, it is clear that the independent variable LATA has a significant relationship with NPR and ROE and does not have a significant relationship with ROA. The correlation between LAT and NPR is 0.725, which shows a strong positive relationship between them and a significant relationship. LAT and ROA have a correlation value of 0.708 and show a significant relationship. Consequently, LAT has a strong positive relationship with ROE with 0.730 and shows a significant

relationship. LAT has a strong positive and significant relationship with all dependent variables NPR, ROA, and ROE.

Finally, CRR has a weak positive, weak negative, and weak positive relationship with NPR, ROA, and ROE with 0.084, -0.134, and 0.205, respectively. CRR has an insignificant relationship with all of these dependent variables.

Table 2

Regression Analysis for Dependent variable of NPR

	B	Std. Error	Beta	t	Sig.
(Constant)	0.472	0.126		3.76	0.009
LATD	3.268	1.022	3.925	3.199	0.019
LATA	-0.148	1.019	-0.07	-0.146	0.889
LAT	-0.450	0.143	-2.598	-3.143	0.02
CRR	-10.894	1.753	-1.262	-6.216	0.001

Table 2 reveals the multiple regression of liquidity variables on NPR. It shows that the regression coefficient is positive for LATD (i.e., 3.268, $p = 0.019 > 0.01$), which means that the higher the LATD higher the impact on ROA but not significantly. But LATA, LAT and CRR show that the negative regression coefficients (i.e. -0.148, -0.450 and -10.894 and $p = 0.889 > 0.01$, $p = 0.02 > 0.01$ and $0.001 < 0.01$ respectively). These results have an inverse relationship between these three independent variables with NPR, which means an increase in these variables would lead to a decrease in ROA but not significantly in the case of LATA and LAT but significantly in the case of CRR vice versa.

Table 3

Regression Analysis of Dependent Variable of ROA

	B	Std. Error	Beta	t	Sig.
(Constant)	0.067	0.013		5.012	0.002
LATD	0.390	0.109	5.35	3.563	0.012
LATA	-0.182	0.109	-0.976	-1.664	0.147
LAT	-0.05	0.015	-3.265	-3.228	0.018
CRR	-1.071	0.188	-1.417	-5.702	0.001

Table 3 presents the multiple regression of liquidity variables on ROA. It shows that regression coefficients are positive for LATD (i.e.0.390, $p = 0.012 > 0.01$), which means that the higher the LATD higher the impact on ROA but not significantly. But LATA, LAT and CRR show that the negative regression coefficients (i.e. -0.182, -0.050 and -1.071and $p = 0.147 > 0.01$, $p = 0.018 > 0.01$ and $0.001 < 0.01$ respectively). These results have inverse relation between these three

independent variables with ROA, which means an increase in these variables would lead to a decrease in ROA but not significantly in the case of LATD and LAT but significantly in the case of CRR vice versa.

Table 4

Regression Analysis of Dependent Variable of ROE

	B	Std. Error	Beta	t	Sig.
(Constant)	0.118	0.096		1.224	0.267
LATD	1.134	0.785	1.405	1.445	0.199
LATA	2.053	0.783	0.997	2.623	0.039
LAT	-0.179	0.11	-1.064	-1.625	0.155
CRR	-8.057	1.346	-0.964	5.986	0.001

Table 4 shows the multiple regression of liquidity variables on ROE. It shows that regression coefficients are positive but not significant for LATD and LATA (i.e.1.134 and 2.053 and $p = 0.199 > 0.01$ and $0.039 > 0.01$ respectively), which means that the higher the LATD and LATA higher the impact on ROE but not significantly. But LAT and CRR show that the negative regression coefficients (i.e. -0.179 and -8.057 and $p = 0.155 > 0.01$ and $0.001 < 0.01$ respectively). These results have an inverse relationship between these two independent variables with ROE. This means an increase in these variables would significantly decrease in the case of CRR, not in the case of LAT on ROE and vice versa.

4. CONCLUSION

The results reveal that there is a positive correlation between loan and advance to total deposit (LATD), liquid assets to total assets (LATA), liquid assets to total assets (LAT) with net profit ratio (NPR), return on assets (ROA) and return on equity (ROE) except cash reserve ratio (CCR) with net profit ratio (NPR), which all are high degree positive correlation showing the fact that the variables have same direction changing relation and the coefficients are significant in the population at 5 percent level of significance since the p-values calculated for the coefficient are less than 0.05. On the other hand, liquidity variables (LATD, LATA, and LAT) have not been significantly associated with NPR, ROA, and ROE except CCR. The finding is consistent with Chaudhary's (2021) and Aithal's (2021) study, which found that the liquidity variables have a mixed relationship with profitability. This study further assessed no significant influence of the independent variable on profitability. It concluded that the independent variable has not significantly influenced profitability but has a strong and positive relationship between independent and dependent variables. The finding is similar to Adhikari's (2021) study, who has revealed that the liquidity variables have no significant impact on profitability.

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