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The effect of reserve requirement ratios on financial performance of commercial banks in Nigeria

*Adamu Ibrahim Shirya[1], Charity Njoka[2], and Farida Abdul[3]

[1]*Department of Business Administration, Sa'adu Zungur University, Bauchi State. Nigeria*
[2&3]*Kenyatta University, Nairobi – Kenya.*

*Corresponding Author: ibrahimshiryaa@gmail.com

Abstract
*This paper examined the relationship between reserve requirement ratios and financial performance of commercial banks in Nigeria. The study was anchored on Keynesian theory, Bank Lending Channel, Agency Theory and employed causal research design. The Nigerian banking populace is 21 commercial banks thus, census approach was adopted. Panel data was utilized and inferential statistical methods were used to analyze the data. The result of regression analysis showed that reserve requirement ratios had a coefficient of β = 76.57011, ***p = 0.000 implying that it had positive and significant effect on the earning performance of commercial banks in Nigeria. The results also show that monetary policy reforms had a coefficient of β=3.031763, ***p=0.002 indicating it has positively and significantly intervened on the relationship between reserve requirement ratios and financial performance of commercial banks in Nigeria a most distinctive finding of the study. The study concluded that reserve requirement ratios as adopted by Central Bank of Nigeria is critical and heavily influenced the performance of banking sector players in Nigeria. The study recommends that Central Bank of Nigeria should be meticulous and involve management of commercial banks when designing policy instruments to enhance the earnings of the commercial banks in Nigeria.*

Keywords: Commercial banks, financial performance, Reserve Requirement Ratios

1. Introduction

The banking sector is one of the most significant components of the financial industry and the overall economy. Its activities are highly regulated compared to other sectors (Iwedi et al., 2023). It plays a vital role in the financial system, particularly in developing economies such as those in Sub-Saharan Africa, including Nigeria, where capital markets are still evolving. The sector facilitates the interaction between lenders and borrowers at legally accepted interest rates while managing credit risk (Thuc, 2019). Consequently, its performance is closely linked to overall economic performance (Kariuki, 2023).

However, the sector faces regulatory challenges due to the nature of its operations (Udeh, 2015). Governments use monetary policy instruments as key regulatory tools, and changes in these policies directly affect banks' operations and financial performance. Profitability remains essential for the long-term survival of commercial banks (Iyere, 2025). A notable illustration of this trend is observed in the United States, where the net interest margin (NIM) of commercial banks declined markedly from 4.04 percent in 1999 to 3.03 percent in 2016, before recording a marginal increase to 3.14 percent in 2017. Similarly, in the United Kingdom, commercial banks' net interest margin

rose substantially from 1.31 percent in 1999 to a peak of 2.91 percent in 2004, but subsequently declined to 2.61 percent in 2017

Furthermore, commercial banks across Sub-Saharan African countries have also experienced the effects of fluctuations in monetary policy instruments. Nevertheless, such alterations often exert adverse consequences on the profitability of the banking sector within the region. For instance, in Ghana, where commercial banks' net interest margin declined from 11.47 percent in 2013 to 11.18 percent in 2017. A similar pattern was evident in Nigeria, commercial banks' net interest margin increased sharply from 6.65 percent in 2010 to an all-time peak of 8.97 percent in 2011, before falling to its lowest level of 5.60 percent in 2016 and subsequently rising to 7.93 percent in 2017 (World Bank, 2026).

Evidence of significant and insignificant findings of relationship between monetary policy instruments and earning performance of banking sector has been registered across context. For instance, at the local context Iyere, (2025) found a significantly negative relationship between cash reserve ratio and commercial banks performance in Nigeria. Udeh (2015) found an insignificant relationship between cash reserve ratio and liquidity ratio and performance of commercial banks in Nigeria. Monday, (2024) evaluates the impact of Monetary Policy on the performance of Deposit Money Banks in Nigeria. The result shows that Monetary Policy Rate (MPR) and Liquidity Ratio (LQR) have no significant impact on Return on Assets (ROA). However, Iyere, (2025), investigated the impact of monetary policies on financial performance of Deposit Money Banks in Nigeria. The research findings indicated that cash reserve ratio has a positive significant effect on financial performance; inflation rate has an insignificant negative effect on financial performance while interest rate has significant negative effect on financial performance of money deposit banks in Nigeria.

Therefore, the inconsistence of findings among researchers or scholars brings a gap that demands for serious further empirical inquiry. Thus, this study therefore, sought to empirically evaluate how reserve requirement ratios significantly influence the performance of banking sector in Nigeria through the intervening effect of monetary policy reforms which has not been carried out in Nigeria. This represents the study's key contribution to the body of knowledge.

A major limitation of the study is the lack of continuous data due to mergers and acquisitions among commercial banks between 2004 and 2010. The sample period (1999–2017) is based on the original MSc thesis from which this article is derived.

The study specifically aims to:

1. Examine the effect of central bank reserve requirements on the financial performance of commercial banks in Nigeria.
2. Determine whether monetary policy reforms mediate the relationship between reserve requirements and financial performance of commercial banks in Nigeria.

2. Literature Review

2.1. Introduction

Commercial banks' operations and financial performance are always affected once central banks adopt monetary policy instruments both in the developed and the developing economies. This section will review the important theories and some of the studies carried out on reserve requirement ratios and financial performance of commercial banks.

2.2. Theoretical Literature Review

This study broadly examined some of the fit transmission mechanisms through which the policy instruments influence the performance of banking sector under the Keynesian Theoretical school of thought, The Banking Lending Channel Theory and the Agency Theory.

2.2.1. Keynesian Theory

The Keynesian Theory, developed by John Maynard Keynes in his 1936 work *The General Theory of Employment, Interest and Money* in United Kingdom, explains how monetary policy influences economic activity through the interest rate channel. The theory emphasizes that monetary policy does not directly affect output; instead, its impact is transmitted indirectly through changes in interest rates, which in turn influence investment, consumption, and overall economic performance.

According to the Keynesian transmission mechanism, when the central bank engages in expansionary policies such as Open Market Operations (OMO), it increases commercial banks' reserves. This leads to an expansion in money supply, causing interest rates to decline. Lower interest rates stimulate borrowing and investment by firms and individuals, thereby increasing aggregate demand and national income. Conversely, contractionary policies reduce money supply, increase interest rates, and may improve banks' margins while discouraging investment.

The transmission process can be summarized as follows:

$$\downarrow OMO \rightarrow \uparrow R \rightarrow \uparrow MS \rightarrow \downarrow r \rightarrow I \rightarrow \uparrow GNP \quad 2.1$$

Where: OMO = Open Market Operations

R = commercial banks' reserve

MS = Stock of Money

MS = Money Supply

R=Interest rate

I = Investment

GNP = Gross National Product

This framework highlights the critical role of financial institutions, particularly banks, in transmitting monetary policy effects to the real economy. The Keynesian Theory is directly relevant to this study as it provides the theoretical foundation for understanding how central bank reserve requirements influence the financial performance of commercial banks. Reserve requirements affect banks' liquidity and lending capacity, which in turn impacts interest rates and profitability (e.g., Net Interest Margin).

Furthermore, the theory supports the hypothesized mediating role of monetary policy reforms. Changes in policy frameworks can alter the effectiveness of the interest rate transmission mechanism, thereby influencing how reserve requirements affect bank performance. Thus, the theory underpins both: The direct relationship between reserve requirements and financial performance and the indirect (mediated) relationship through monetary policy reforms.

2.2.2. Bank Lending Channel Theory

The Bank Lending Channel Theory, developed by Ben S. Bernanke and Alan S. Blinder United States and later expanded by Anil K. Kashyap and Jeremy C. Stein (2000), is a key component of the credit view of monetary policy transmission. The theory posits that monetary policy influences economic activity not only through interest rates but also through its direct effect on the availability of bank credit. Specifically, policy actions alter bank reserves and deposits, thereby affecting banks' capacity to extend loans.

According to this theory, when monetary authorities implement contractionary policies, banks experience a reduction in loanable funds due to tighter reserve conditions. Conversely, expansionary policies increase the availability of reserves, enabling banks to extend more

credit. Thus, the supply of bank loans serves as a crucial transmission mechanism linking monetary policy to economic outcomes and financial performance.

The theory is relevant to Study Objective 1(Investigate the effect of reserve requirement ratios on financial performance of commercial banks in Nigeria) since provides a direct explanation of how reserve requirement ratios, particularly the Cash Reserve Ratio (CRR) set by the Central Bank of Nigeria, influence the financial performance of commercial banks.

An increase in reserve requirements compels banks to hold a larger proportion of their deposits as non-earning reserves, thereby reducing the funds available for lending. This contraction in loan supply can lead to a decline in interest income, reduced net interest margins, and ultimately lower profitability indicators such as Return on Assets (ROA).

On the other hand, a decrease in reserve requirements increases banks' liquidity, enhances their lending capacity, and may improve profitability through higher interest earnings. However, the theory also suggests that such effects depend on banks' ability to efficiently allocate credit and manage associated risks.

The Bank Lending Channel Theory also supports Study Objective 2(Examine the intervening effect of monetary policy reforms on the relationship between reserve requirement ratios and financial performance of commercial banks in Nigeria) the role of monetary policy reforms as an intervening variable in this relationship. Reforms such as changes in policy frameworks, liquidity management strategies, or adjustments to reserve requirements can alter how effectively reserve ratios influence bank lending and performance.

For instance, reforms that improve financial market efficiency, strengthen banking regulations, or enhance policy transmission mechanisms may either amplify or moderate the impact of reserve requirements on bank performance. In Nigeria, periodic reforms by the Central Bank of Nigeria—such as liquidity tightening measures, CRR debits, and policy rate adjustments—can reshape banks' responses to reserve constraints.

These reforms influence how banks adjust their portfolios, manage liquidity, and respond to risk. As a result, the relationship between reserve requirement ratios and financial performance is not static but depends on the broader monetary policy environment shaped by such reforms.

2.2.3. Agency Theory

Agency Theory developed by Michael C. Jensen and William H. Meckling (1976) New York, USA, explains the relationship between principals (shareholders) and agents (managers) in an organization. The theory posits that conflicts of interest may arise because managers may pursue personal objectives rather than maximizing shareholders' wealth.

In the context of commercial banks, managers are responsible for making financial and strategic decisions that affect profitability and overall performance. However, without proper monitoring and incentives, managers may engage in actions that do not align with shareholders' interests, thereby reducing financial performance.

To mitigate agency conflicts, mechanisms such as performance-based incentives, ownership structures, and corporate governance controls are implemented to ensure that managers act in the best interest of shareholders.

Agency Theory is relevant to this study as it explains internal factors that influence the financial performance of commercial banks, particularly Net Interest Margin (NIM). While monetary policy

instruments such as reserve requirements affect banks externally, the extent to which these policies impact performance depends on managerial decisions and efficiency.

The theory supports the study hypotheses in the following ways: It explains how bank management responds to regulatory changes (e.g., reserve requirements) in ways that affect profitability, it highlights that financial performance is not determined by policy alone but also by managerial behavior and governance structures and it reinforces the idea that monetary policy reforms may influence how effectively managers adapt to regulatory changes, thereby affecting performance outcomes.

2.3. Empirical Literature Review

The relationship between reserve requirement ratios and the performance of financial institutions remains a subject of intense debate, characterized by conflicting empirical results and varying methodological approaches. This review critically synthesizes global and local perspectives, highlighting thematic inconsistencies and the resulting research gaps.

International studies demonstrate that the impact of monetary policy is heavily contingent on the specific economic environment and the chosen econometric model.

Thanh, Ngock, and Ha (2017), evaluate the impact of factors on the capital adequacy ratio of commercial banks listed on the Vietnamese stock market in. The research utilized panel data regression of 25 listed banks to establish that the reserve ratio and discount rate bear a negative relationship with bank earnings. Their findings underscore a fundamental constraint: restrictive monetary tools directly compress the margins of commercial banks. In contrast, Eugene (2024) assessed the effect of monetary policy on financial performance of domestic and foreign commercial banks in Rwanda. The study employed a more nuanced approach by comparing domestic and foreign banks using a binary logit model. Interestingly, while Eugene found that local banks generally outperformed foreign counterparts in terms of Return on Assets (ROA), the study revealed a paradox: money supply and discount rates affected both types of banks identically. This suggests that while macro-level monetary policy creates a uniform "playing field," institutional efficiency remains the primary driver of performance variance.

Research within Nigeria presents a fragmented picture, particularly regarding which instruments effectively drive or hinder profitability.The contradictions are stark. For instance, while Iyere (2025) and Chukwudi & Chukwubuzo (2023) argue that the Cash Reserve Ratio (CRR) enhances long-term performance by stabilizing the lending environment, Udeh (2015) found that CRR and liquidity ratios had no significant impact on Profit Before Tax (PBT). These discrepancies may stem from sample bias, as Udeh's study was limited to a single institution (Zenith Bank), thereby lacking the generalizability found in the census-style approach of more recent studies.

Many studies are constrained from outdated data ranges or fail to account for the structural shifts in the Nigerian economy. For example, the "pre and post-consolidation 2004/2005, global financial 2008/2009 crisis, and economic recession 2016" periods mentioned by Monday (2024) indicate that policy effects are not static but evolve with the regulatory landscape.

Also, most existing studies utilize a direct linear model: However, they largely ignore the intervening effects of monetary policy reforms. As noted by the critique of Udeh (2015), ignoring how specific regulatory reforms (like the 1999–2017

shifts) modify the relationship between monetary policy instruments and outcomes leaves a significant "research gap" in the analysis.

The literature is replete with conflicting evidence—ranging from the negative impacts found by Hassan & Ahmad (2022) to the positive long-run relationships identified by Omankhanlen et al. (2021). These inconsistencies are likely the result of varying proxies for performance (ROA vs. PBT vs. NIM), diverse econometric techniques (OLS vs. ARDL vs. Panel Data), and limited geographical scopes.

By choosing the study from (1999–2017) to cover the "pre and post-consolidation 2004/2005, global financial 2008/2009 crisis, and economic recession 2016" periods, introducing monetary policy reforms as an intervening variable to investigate whether it provides a mechanism for reserve requirement ratios to influence financial performance of commercial banks in Nigeria. This research moves beyond mere correlation. It seeks to provide a more sophisticated understanding of the mechanisms through which central bank interventions actually affects the financial performance of Nigerian commercial banks which the most unique contributions to this study.

3. Methodology

The study utilized multivariate random effect regression model in investigating the relationship between reserve required ratio and financial performance of commercial banks in Nigeria through the mediating effect of monetary policy reforms and recommendation made (Breusch & Pagan, 1979). Thus, financial performance of commercial banks in terms of Net Interest Margin (NIM) was express as a function of CRR and Monetary Policy Reforms (MPRE)

$Y_t = \beta 0 + \beta_1 X_{1t} + \mu t$

Yi_t = financial performance (NIM) of Commercial Banks in Nigeria,

Where i = Bank and time = t

Net Interest Margin is the ratio of a bank's net interest income to its average interest-earning assets over a specific period and it is determine as follows:.

$$\text{Net Interest Margin (NIM)} = \frac{\text{Interest Income} - \text{Interest Expense}}{\text{Average Interest-Earning Assets}} \times 100$$

The Reserve Requirement Ratio (RRR) is the percentage of a bank's total customer deposits that must be kept as reserves**,** either in the bank's vault or with the central bank, and cannot be used for lending or investment**.** It is determine as:

$$\text{Reserve Requirement Ratio (RRR)} = \frac{\text{Required Reserves}}{\text{Total Deposits}} \times 100$$

3.2. Mediating Effect Model

The test of mediating effect was based on Whsman and McClelland (2005).

Based on two steps:

Step 1:

$$Y_t = \beta 0 + \beta_1 X_{1t} + \beta_2 X_{2t} + \mu t \quad 3.2$$

Step 2:

$$Y_t = \beta 0 + \beta_1 X_{1t} + \beta_2 X_{2t} + \beta_3 X_i M_{it} + \mu t \quad 3.3.$$

4. Results and Discussion

4.1. Statistical Analysis

4.2. Descriptive Statistical Analysis

This section presents the descriptive statistics results on the study variables. The descriptive statistics used in this section include mean, standard deviation, minimum and maximum values as the results are presented in Table 4.1.

Table 4.1 Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Central Bank Reserve Requirement	136	717.6948	326.3804	170.38	1232.775
Monetary Policy Reform	136	25.85875	2.749252	21.86	30.99
Financial Performance	126	90808.67	75688.92	5842	331522

Source: *Researcher (*2026)

From Table 4.1 the results show that the mean central bank reserve requirement which was obtained by the product of cash reserve ratio and statutory liquidity ratio also changed significantly during the study period as indicated by standard deviation of 326.3804 implying central bank reserve requirement has a great unfavourable effect on the financial performance of commercial banks in Nigeria.

The results further show that monetary policy reform oscillated between 21.86 and 30.99 with standard deviation of 2.749252 which changes are insignificant during the study period. This mean that variation in monetary policy reforms have positive effect on the performance of commercial banks in Nigeria. These finding confirmed that monetary policy instruments in Nigeria were very dynamic depending on the economic environment. This finding concur with those of Udeh, (2015) who posited that Nigeria's monetary policy tools have undergone various forms of changes to manage and survive the instabilities in economic indices. The changes in these monetary policy instruments also affect banks operations and financial performance as shown by changes in net interest margin between 6.71% and 5.65%. The findings support those of Monday, (2024) who found that monetary policy instruments affect the operations of commercial banks. Reression Analysis Results of Monetary Policies Instruments and Financial Performance of Commercial Banks in Nigeria

The inferential statistics adopted by the study was random effect regression analysis. The study adopted the multivariate random effect regression model to test for research hypotheses at a 5 per cent significance level.

Table 4.2 Random Effect Regression Coefficients Results

Financial Performance	Coef.	Std. Err.	z	P>|z|	[95% Conf.	Interval]
Bank Reserve Requirement	76.57011	20.94311	3.66	0.000	35.52238	117.6179
_cons	34616.87	23808.95	1.45	0.146	-12047.8	81281.56

Model Summary

Wald chi2(2) = 62.97

Prob>chi2 = 0.0000

R-sq: within = 0.3664

Source: *Researcher (*2026)

4.2.1. Hypotheses Testing

4.3.1 H_{01}: Reserve Requirement ratios Do Not Have Significant Effect on Financial Performance of Commercial Banks in Nigeria

4.3.2 The hypothesis of the study was H_{01}: central bank reserve requirement does not have significant effect on the financial performance of commercial banks in Nigeria. The results in table 4.2 show that central bank reserve requirement had a coefficient of β=76.57011, ***p=0.000 implying that central bank reserve requirement had positive significant influence on financial performance of commercial banks in Nigeria. The study also rejected H_{01} that central bank reserve requirement does not have significant effect on the financial performance of commercial banks in Nigeria. The findings of this study support Keynesian Theory who believed that variations in money supply directly affect prices and output or income (GNP) (Jinghan,1997) and also those of Thuc et el., (2019) who study findings indicated that the amount of funds commercial banks deposit with CBK as cash reserve requirement has positive effect on commercial banks' profitability Kenya. $H_{02:}$ Monetary Policy Reform Does Not Have Significant Intervening Role on Relationship between Monetary Policy and Financial Performance of Commercial Banks in Nigeria

The study also tested the second hypothesis (**H_{02}**) based on Whisman and McClelland (2005) which include two steps. The first was conducted with the intervening variable directly predicting financial performance while the second step involved using monetary policy reform as an intervening variable.

4.2.2. Step One Test for Intervening effect of Monetary Policy Reform

In this step, a regression analysis was conducted with intervening variable (monetary policy reform) predicting financial performance of commercial bank in Nigeria as in shown in Table 4.3.

Table 4.3(a) Step One Test for Intervening effect of Monetary Policy Reform

C	Coef.	Std. Err.	Z	P>|z|	[95% Conf.	Interval]
Bank Reserve Requirement	77.34351	19.33529	4.000	0.000	39.44705	115.24
Monetary Policy Reform	13.6181	4336.288	0.000	0.997	-8485.35	8512.587
_cons	34338.68	91676.65	0.370	0.708	-145344	214021.6

Wald chi2(4) = 82.72
Prob>chi2 = 0.0000
R-sq: within = 0.4362

Source: *Researcher (*2026)

The results show that monetary policy reforms had a coefficient of β=13.6181, ***p=0.997 which implied that monetary policy reforms was not a predictor variable of financial performance of commercial banks in Nigeria and therefore it could be used as a mediating variable only.

4.2.3. Step Two Test for Intervening effect of Monetary Policy Reforms

This section presents the results of the second step in the test of intervening effect of monetary policy reform on

relationship between monetary policy instrument and financial performance of commercial banks in Nigeria. The study computed the interaction variables (X_1*Z,) which was obtained by a product of independent variable and intervening variable. The significant of interaction variables were considered for intervening effect as shown in Table 4.9(b).

Table 4.3 (b) Step Two Test for Intervening effect of Monetary Policy Reforms

Financial Performance	Coef.	Std. Err.	z	P>|z|	[95% Conf.	Interval]
Bank Reserve Requirement	75.95785	8.238306	9.22	0.000	59.81107	92.10463
Monetary Policy Reform	15874	15577.52	1.02	0.308	-14657.4	46405.38
X_1*Z	3.031763	0.995814	3.04	0.002	1.080002	4.983523
_cons	-294579	334006	-0.88	0.378	-949219	360060.6

Wald chi2(7) = 82.99
Prob>chi2 =0.0000
R-sq: within = 0.4441

Source: *Researcher (*2026)

From the results presented in Table 4.3 (b) X_1*Z (β=3.031763, ***p=0.002) was found to be significant. The findings implied that monetary policy reforms significantly intervene the relationship between bank reserve requirement and financial performance of commercial banks in Nigeria a most exceptional findings of the study.

5. Conclusion and Recommendations

Researchers have conducted studies on reserve requirement ratios and financial performance of commercial banks in advanced economies. Similarly, a few studies have conducted on reserve requirement ratios and financial performance of commercial banks in Nigeria have shown inconsistent results. However, these studies did not consider the intervening characteristics and its impact on the relationship between monetary policy instruments and financial performance of commercial banks in Nigeria. Hence this study sought to address these research gaps.

The results of regression analysis showed that reserve requirement ratios had a significant influence on financial performance of commercial banks in Nigeria and concluded that reserve requirement ratios have significant effect on the financial performance of commercial banks in Nigeria. Also, the findings implied that monetary policy reforms significantly mediated the relationship between reserve requirement ratios and financial performance of commercial banks in Nigeria which the most unique findings of the study.

Based on the findings, the study made the following conclusions; first, the study concluded that monetary policies instruments are critical to the growth and expansion of banking sector in Nigeria and many countries. The financial performance of banking sector players is heavily influenced by the reserve requirement ratios adopted by Central

Bank as shown by the study findings. The study further concluded that financial performance of stable banking sector remain steady even though monetary policy instrument changes which impact on the operating environment of industry players. The study finally concluded that the monetary policy reforms play a significant role in ensuring the operating environment in the banking sector remain buoyant to enhance the financial performance of industry players.

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