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EFFECT OF RISK MONITORING ON PERFORMANCE OF FINANCIAL INSTITUTIONS

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Abstract

Purpose*:* The purpose of the study was to examine the effect of risk monitoring on performance of financial institutions.

Methodology: The study used explanatory research design. The study used stratified random sampling to select respondents from target population comprising of managers of 46 commercial banks, 52 Micro Finance institutions (MFIs) and 200 SACCOs and a sample size of 239 respondents obtained. Data was collected using questionnaires. Descriptive statistics was presented, while inferential statistics was done using Pearson product moment correlation. **Results:** Risk monitoring [$r = 0.206$, $p<.05$] had a positive relationship performance of financial institutions. The more there was risk monitoring the higher the performance of financial institutions. A proper risk monitoring practices was used to ensure that risks are in line with financial institution's management goals in order to uncover mistakes at early stages. The risk monitoring had positive relationship on performance of financial institutions ($P<0.05$). The null hypothesis (HO4) stating that there is no significant effect of risk monitoring on the performance of financial institutions was rejected. The risk evaluation should be enhanced so as to enhance the performance of financial institutions. These may be achieved through establishing regulatory mechanism that can be adopted to enhance effective risk identification.

Unique contribution to theory, practice and policy: The risk monitoring should be enhanced so as to enhance the performance of financial institutions. These may be achieved through establishing regulatory mechanism that can be adopted to enhance effective risk identification.
Key words*: Risk montoring, performance, financial institutions*

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1.0 INTRODUCTION 1.1 Background of the Study

According to Dayson *et al*., (2006), microfinance has been attractive to lending agencies because of demonstrated sustainability and low cost of operations. Results of these studies strongly suggest that bank profitability determinants vary across countries and also among regions of the world (Doliente, 2003). In accordance with the study of Grier (2007), profitability ratios are often used in a high esteem as the indicators of credit analysis in banks, since profitability is associated with the results of management performance. Bank performance indicates bank's capacity to generate sustainable profits. Banks protect the profitability against unexpected losses, as it strengthens its capital position and improves future profitability through the investment of retained earnings. A bank that persistently makes a loss will ultimately deplete its capital base, which in turn puts equity and debt holders at risk.

The International Monetary Fund (IMF, 2014) survey on financial performance of Sub-Sahara Africa home grown institutions finds that risks were increasing and negatively affected the financial performance of firms in the region. The report further outlines various risks such as; declining prices for commodity goods, fiscal vulnerabilities, security, and growing capital flows were dynamics for risk management. In some countries for instance in Ghana growing deficits in the national budget and political instability was affecting the local currencies against the major currencies and therefore putting pressure on locally produced goods. While in the case of Zambia, general increase in wages was affecting firms 'income by increasing cost of production. Generally the increasing insecurity rates in Central Africa Republic and Southern Sudan was the main reason behind the continuous factors that affected growth prospects of the local firms in the region (IMF, 2014).

In order to create shareholder value, bank's return on equity (ROE) needs to be greater than its cost of equity. Return on equity, ROE, and return on assets and ROA are the most commonly used ratios, and the quality level of ROE is between 15% and 30%, for ROA is at least 1%. *Wong et al.*, (2008) indicated that the efficiency of banks can be measured by using the ROE which illustrates to what extent banks use reinvested income to generate future profits. According to Riksbank's Financial Stability Report (2002), the measurement of connecting profit to shareholder's equity is normally used to define the profitability in the banks. Jensen Investment Management (2008) mentioned that ROE provides a very useful gauge of profit generating efficiency because it measures how much earnings a company can get on the equity capital.

European Central Bank (2010) looks at financial performance of banks from the perspective of analyzing the main drivers of profitability; earnings, efficiency, risk-taking and leverage. The report goes on to note that the performance however needs to incorporate the views of various stakeholders (e.g. depositors, debt or equity holders and managers). The CAMELS model, a recent tool of financial analysis also provides a framework for measuring financial performance of banks. According to the parameters bank financial performance is looked at in the perspective of the internal strength of the bank, loan portfolio quality, management efficiency, liquidity management and the banks sensitivity to risk.

A study conducted by Hakkak and Ghodsi (2015) revealed that implementation of non-financial performance measures in organizations has a significant positive effect on firms' competitive advantage and sustainability. "The organization's ability to achieve long-term goals is based on its financial performance" (Wheelen & Hunger, 2000). Financial performance is the measurement of

the result achieved or expected in the light of predetermined criteria to determine what can be measured (Al-Hannawi, 2009).

Several studies have also been done on determinants of banks' profitability locally and across the globe. Globally, a study by Athanasoglou and Delis (2005) evaluated impact of industry-specific, bank-specific and macro-economic determinants of commercial banks profitability and established that all bank-specific determinants, apart from size, influence banks profitability. In addition, Roman and Tomuleasa (2013) evaluated the effect of specific internal and external factors on profitability of the banks in the new European Union member states and established that both bank specific factors like capital adequacy, NPL, income and external factors, like GDP growth rate and inflation affect commercial banks profitability. However, majority of the available international studies combine both the bank specific factors with the industry and other macro-economic factors. In the recent decade both macro and micro finance institutions have emerged in the banking industry limiting chances of survival to non performing institutions. Poor bank performance may lead to banking failure and crisis, which have negative consequence on the economic growth (Ongore & Kusa, 013). It has become critical for bank managers, academic researchers and other stakeholders to understand the current determinants of financial performance towards attaining high profitability and good performance which ensures survival in business.

1.2 Statement of the Problem

Performance refers to money that a firm can produce with the resources it has. The goal of most financial institution is profit maximization (Niresh & Velnampy, 2014). Profitability involves the capacity to make benefits from all the business operations of a financial institution (Muya & Gathogo,2016).Theoretically, risk management plays a key role in improving firms' financial performance (Kaplan *et al.,* 2008).Risk management affect financial performance of a firm by reducing surprises arising from business complexities, unpredictable business environment and evolving risks. Effective risk management practices and profitability when aggregated affects financial performance of firms in today's competitive environment, profitability is a key factor for smooth running of the business that has a significant effect on performance of the bank and economic development as well ;Tariq *et al*., (2014).

Financial institutions are bestowed with an imperative responsibility to execute in the economy by acting as intermediaries between the surplus and deficit units, making their job as mediators of critical significance for efficient allocation of resources in the modern economy;El-Hawary *et al.*, (2007). The stability of the entire economy is affected by a crumple of the financial institutions, as a result a robust risk management system is mandatory to keep the financial institutions up and running (BNM, 2008; Blunden, 2005). Risk management is an issue that needs to be stressed and investigated, especially in the banking industry, where the need for a good risk management structure is extremely important.

In the financial sector, risk management is seen as one of the most essential internal itineraries upon which decisions are made by financial institutions (Pauzuolis, & Cvilikas 2014). A good risk management framework helps the institution to protect from unfavorable consequences (downside risks) and permit the institution to take the benefit of any possible opportunities (up-side risks).

Moreover, as the nature of business for financial institutions are accepting and managing credit risk, thus they act as shock absorbers.

Ludquist (2014) identified the possibility that ownership structure tamper the magnitude of relationship between risk management and firm performance. Ownership structure to banks is important because the basic motivation of owners of capital is to maximize their wealth by enhancing the value. (Eduardus *et al.,* 2007) study on ownership structure of financial institutions finds ownership to some extent determines their risk management approaches, and these in turn affect their performance .One may wonder whether these factors may affect each other, and thereby affect performance jointly, this study sought to determine this gap.

There are few local studies on risk management which include; Kimeu (2008) who studied credit risk management techniques of unsecured banks loans of commercial banks in Kenya, Ngare (2008) who studied credit risk management practices by commercial banks, Simiyu (2008) studied techniques of credit risk management in microfinance institutions in Kenya, Mutwiri (2007) studied credit risk management practices by oil companies in Kenya, Muteru (2007) who studied credit risk management practices by Pharmaceuticals manufacturing firms in Kenya, Mwirigi (2006) who studied credit risk management techniques adopted by micro finance institutions in Kenya and Njiru (2003) who studied credit risk management by coffee co-operatives in Embu District.

1.3 Objectives of the Study

The general objective was to determine the effects of risk monitoring on performance of financial institutions.

2.0 LITERATURE REVIEW 2.1 Theoretical Review

2.1.1 Risk Management Theory

Wenk (2005), states that the Risk Management model consists of risk identification, risk assessment, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events or to maximize the realization of opportunities. Risks can come from uncertainty in financial markets, project failures, legal liabilities, credit risk, accidents, natural causes and disasters as well as deliberate attack from an adversary, or events of uncertain or unpredictable root-cause. Several risk management standards have been developed including the Project Management Institute, the National Institute of Science and Technology, actuarial societies, and ISO standards. Methods, definitions and goals vary widely according to whether the risk management method is in the context of project management, security, engineering, industrial processes, financial portfolios, actuarial assessments, or public health and safety (Simkins & Fraser, 2010).The strategies to manage risk typically include transferring the risk to another party, avoiding the risk, reducing the negative effect or probability of the risk, or even accepting some or all of the potential or actual consequences of a particular risk.

Effective risk management can bring far reaching benefits to all organizations, whether large or small, public or private sector (Ranong & Phuenngam, 2009). These benefits include, superior financial performance, better basis for strategy setting, improved service delivery, greater competitive advantage, less time spent fire fighting and fewer unwelcome surprises, increased likelihood of change initiative being achieved, closer internal focus on doing the right things properly, more efficient use of resources, reduced waste and fraud, and better value for money, improved innovation and better management of contingent and maintenance activities (Wenk, 2005).Effective risk management structure supports better decision making through a good

understanding of the risks and their likely impact. In practicing Risk Management (RM), if risks are left unmanaged, they can cause a negative impact on stake holder's value. It therefore means that good risk management enhances shareholders value. By creating a good discipline in risk management it helps improve governance process and therefore improves effectiveness (Moore; 1983).

According to Dorfman (2007) ensuring that an organization makes cost effective use of risk management first involves creating an approach built up of well-defined risk management and then embedding them. These risk management include financial risks management, operational risk management, governance risk management, and strategic risk management. The theory of Risk Management Theory is applied in the study to determine the effects of risk management on financial performance of financial institutions in Kenya.

2.2 Empirical Studies

To monitor and control risk some requirements are needed to ensure the implementation of the risk plans and the evaluation of their effectiveness in reducing risk, to keep track of identified risks, which includes the watch list and to update the organizational process. Monitoring is an important procedure to ensure that risk management is practiced by financial institutions effectively (Javid, 2009). Effective risk management also means the execution of a reporting and review structure to ensure that risks are identified and assessed, after which appropriate controls and responses are set in place. Proper risk monitoring practices can be used to ensure that risk management practices are in line and that it also helps the financial institution's management to uncover mistakes at early stages (Al-Tamimi & Al-Mazrooei, 2007).

Monitoring is the final step in the corporate risk management process (Pausenberger & Nassauer, 2002). Control by the management board is insufficient to ensure the effective functioning of the risk monitoring system. This is because the management board members do not have sufficient time to exercise extensive control. Hence, the management board will put in place an independent unit to be responsible for internal supervision. The internal audit will normally be responsible for this task. The supervisory board too is obligated to control the risk management process. The supervisory board is supported by the auditor. Any defect by the auditor must be told to the supervisory board and the management board. The shareholders of financial institutions exercise the rights to insist on getting information in order to judge the efficiency of the risk management system. Here the director's report enabled the shareholders to assess and view the status of the corporation thoroughly.

3.0 RESEARCH METHODOLOGY

The study used explanatory research design. The study used stratified random sampling to select respondents from target population comprising of managers of 46 commercial banks, 52 Micro Finance institutions (MFIs) and 200 SACCOs and a sample size of 239 respondents obtained. Data was collected using questionnaires. Descriptive statistics was presented, while inferential statistics was done using Pearson product moment correlation.

4.0 RESULTS

4.1 Demographic Information of the Respondents

A total of 279 questionnaires administered to the respondents but only 236 were used in the analysis and this accounted for a response rate of 81.7% which was found to be very good. This agrees with Babbie (1990) that a response rate of over 70% is very good. Although these are rules of thumb that ignore the compounding effect of sampling, measurement, and coverage errors. The

demographic information sought from the respondents included; the gender, age, educational level, department worked, duration the firm has been in operation. All these were relevant in establishing the extent to which personal characteristics may influence risk management practices as summarized in table 1. Majority of the respondents involved in the study were male. Of the 236 respondents included in the study, 58.5% (138) were male, while 41.5% (98) were female. This indicates that there was gender disparity in the employees working in financial institutions in Kenya.

Regarding age, the results showed that 30.5% (72) of the respondents were in the age bracket of 35 and 44 years, 29.2% (62) were in the age bracket of 25 and 34 years and 26.3% (62) were in the age bracket of 45 and 54 years and 8.9% (21) were over the age of 54 years. The findings showed that dominant 64.8% (153) of the tea firms' employees were in their active working age of below 44 years. The academic levels of employees were varied and 61 (25.8%) had diploma qualification, 104 (44.1%) had degree, 64 (27.1%) having masters, 3% had PhD. The findings indicated that majority of the employees had at least a diploma as the highest level of Education and were in good position to perform well during the adoption of risk management practices. During the study 88 of the respondents (37.3%) held the position of credit officers, 49(20.8%) as risk and compliance, 43 (18.2%) from mortgage department and 56(23.7%) from debt recovery. Regarding duration of operation of the financial institution, the results showed that 50.4% had been in operation for between 26 and 30 years', 16.5% between 16 and 20 years', with 11.9% between 11 and 15 years, while10.6% between 6 and 10 years and 7.2% being in operation between 21 and 25 years. The findings showed that most of the financial institutions had been in operation for more than 20 years.

Table 1: Respondents Demographic Characteristics

	Response	Frequency	Percent
Gender	Male	138	58.5
	Female	98	41.5
	Total	236	100.0
Age bracket	18-24 years	12	5.1
	25-34 years	69	29.2
	35-44 years	72	30.5
	45-54 years	62	26.3
	55– 64 years	21	8.9
	Total	236	100.0
Highest level of education	Diploma	61	25.8
	Bachelors	104	44.1
	Masters	64	27.1
	PhD	7	3.0

	Total	236	100.0
Type of department	Credit	88	37.3
	Risk and compliance	49	20.8
	Mortgage	43	18.2
	Debt recovery	56	23.7
	Total	236	100.0
Duration of operation of the institution	0-5 years	8	3.4
	6-10 years	25	10.6
	11-15 years	28	11.9
	16-20 years	39	16.5
	21-25 years	17	7.2
	26-30	119	50.4
	Total	236	100.0

4.2 Financial Institution Background Information

The background Information of financial institution sought from the respondents included; duration the financial institution implemented risk management compliance, nature of activities and size of the firm. All these were relevant control variable in establishing the extent to which risk management practices maybe influenced by size of the firm as summarized in table 2.

Table 2: Financial institution Background Information

	Response	**Frequency**	**Percent**
Duration the financial institution implemented risk management compliance	0-1years	7	3.0
	2- 4 years	56	23.7
	5-7 years	39	16.5
	8-10 years	47	19.9
	11-15 years	37	15.7
	15 years and above	50	21.2
	Total	**236**	**100.0**
Nature of activities	Commercial Banking	109	46.2
	Investment banking	28	11.9
	offshore banking	17	7.2
	Foreign Banking	3	1.3
	Investment (including funds)	9	3.8

	Stock brokers	17	7.2
	Deposit Taking	53	22.5
	Total	**236**	**100.0**
Size of the Firm	Large (Over 40 Bn Assest)	40	16.9
	Medium (10-40 Bn)	56	23.7
	Small (below 10m)	140	59.3
	Total	**236**	**100.0**

Regarding duration the financial institution has implemented risk management compliance, the results showed that 21.2% had implemented risk management compliance for more than 15 years', 19.9% between 8 and 10 years', with 16.5% between 5 and 7 years, while 15.7% between 11 and 15 years. The findings showed that most of the financial institutions had implemented risk management compliance for more than 5 years. This concurs with Hull, (2012) that commercial banking in virtually all countries has been subject to a great deal of regulations. One of the regulations is the minimum capital commercial banks must keep absorbing loss if unexpected things happen. This kind of capital requirement is, in particular, conducted by Basel Committee which aims to enhance the key supervisory issue and improve the quality of banking supervision (Bis.org, 2014).

On the nature of activities the commercial bank 109 (46.2%)of the respondents identify the financial institutions engage in commercial banking activities, 22.5% deposit taking, with 11.9% in investment banking, 7.2% in offshore banking and stock brokers. This indicated that most of the financial institutions engage in banking. On the size of the firm most of the financial institutions 140(59.3%) had a small asset base of below 10 million, with 32.7% being medium sized with 10 to 40 million asset base and 16.9% with large asset base of over 40 billion. This indicates that commercial banks hold deposits, bundling them together as loans and operating payments mechanism.

4.3 Factor Analysis Risk Monitoring

The factor analysis results of risk monitoring, indicated that the KMO was 0.822 and the Bartlett's Test of sphericity was significant ($p<.05$). The Varimax rotated principle component resulted in three factor loading on risk monitoring variable that explained 63.39 % of variance with Eigen values larger than 1 (table 3). Since all the statements conform, they were computed and renamed monitoring for further analysis.

Table 4: Factor Analysis of Risk Monitoring Rotated Component Matrix[a]

	Component		
	1	2	3
Shareholders demand information in order to judge the efficiency of the risk management system	.697		
Effective risk management requires a reporting and review structure	.564		
Ensure that risks are effectively identified and assessed	.518		

Ensures appropriate controls and responses are in place.			.803
Monitoring is the last step in the corporate risk management process			.836
Risk monitoring can be used to make sure that risk management practices are in line	.735		
Proper risk monitoring helps bank management to discover mistake at early stage	.813		
The area of interest rate risk is a major concern and ongoing risk monitoring and is important for banks,		.694	
Risk monitoring helps the bank management to discover mistake at early stage		.763	
Risk monitoring enables the shareholders to as¬sess the status of the corporation thoroughly		.735	
Kaiser-Meyer-Olkin Measure of Sampling Adequacy.	.822		
Bartlett's Test of Sphericity (df-45) **Total**	.000		
Variance Explained	63.390		

Extraction Method: Principal Component Analysis.

Rotation Method: Varimax with Kaiser Normalization. a. Rotation converged in 5 iterations.

4.4 Correlations

Pearson moment correlation was used to describe the relationship between independent and dependent variables, depending on the level of measurement. The relationship between independent variable (risk management practices) and dependent variable (performance of financial institutions) were investigated using Pearson product-moment correlation coefficient as shown in table 5. There was a positive relationship between risk identification and performance of financial institutions [r = .306, *n* = 236, p<.05]. This indicated the more risk identification the higher the performance of financial institutions. This agrees with Al-Tamimi and Al-Mazrooei (2007) that risk identification is the initial stage of risk management. For the implementation of risk management in an organization, the first step is to study risks and their impact on management practices. Also agree with Tchankova (2002) who concludes that risk identification was a very important step in risk management.

A positive relationship exist between risk analysis and performance of financial institutions [r = .385, *n* = 236, p<.05]. This showed that an increase in risk analysis the higher the performance of financial institutions. This agrees with Lagat *et al.* (2013) that, most of these financial institutions have adopted risk management practices as one way of managing their portfolio.

Table 5: Pearson moment correlation Results

		Performance	**Monitoring**
Performance	1		
Monitoring	.206**		1

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

*. Correlation is significant at the 0.05 level (2-tailed). c.
Listwise N=236

Risk monitoring had a positive relationship on performance of financial institutions [r = .206, *n* = 236, p<.05]. This showed that the more there is risk monitoring the higher the performance of financial institutions. This agrees with Al-Tamimi and Al-Mazrooei, (2007) that proper risk monitoring practices can be used to ensure that risk management practices are in line and that it also helps the financial institution's management to uncover mistakes at early stages.

5.0 SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS 5.1 Summary of Findings

The objective of the study was to establish the effect of risk monitoring on performance of financial institutions in Kenya. Risk monitoring [r = .206, p<.05] had a positive relationship performance of financial institutions. The more there was risk monitoring the higher the performance of financial institutions. A proper risk monitoring practices was used to ensure that risks are in line with financial institution's management goals in order to uncover mistakes at early stages. The risk monitoring had positive relationship on performance of financial institutions (P<0.05). The null hypothesis **(H_{O4})** stating that there is no significant effect of risk monitoring on the performance of financial institutions was rejected.

5.2 Conclusions

The risk management practices (monitoring) had positive relationship with the performance of financial institutions. The risk evaluation management practices highly predicted the performance of financial institutions.

5.3 Recommendations

The risk monitoring should be enhanced so as to enhance the performance of financial institutions. These may be achieved through establishing regulatory mechanism that can be adopted to enhance effective risk identification.

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