International Journal of
Business Strategies
(IJBS)

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AJP

International Journal of Business Strategy
ISSN 2519- 0857 (Paper)
Vol.2, Issue 1 No.5, pp 75- 87, 2017

www.ajpojournals.org

EFFECT OF RISK IDENTIFICATION ON PERFORMANCE OF FINANCIAL INSTITUTIONS

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Abstract

Purpose: The purpose of the study was to determine the effect of risk identification 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: From the model results, the risk identification (β=0.026) was not significantly related to financial performance.
Unique contribution to theory, practice and policy: The study recommends regulators to consider and appropriately legislate risk identification practices to enhance performance of financial institutions.

***Key words**: Risk identification, performance, financial institutions*

1.0 INTRODUCTION

1.1Background of the Study

Performance is "a reflection of the organization's capacity and its ability to achieve its objectives" (Eccles, 1991). Performance is an indicator explaining the level of development of any society. Recently, the challenges of the global business environment have re-echoed the need for corporate organizations to have more concerns about the success of business firms. Firm performance has been viewed as one of the most important variables that attracted the attention of researchers in both finance and management literature (Gavrea, Ilies & Stegerean, 2011).

Firm performance is a concept that explains the extent to which an organization achieves objectives. It indicates how organizations have been scrutinizing key business activities over time (Saeidi *et al.,* 2014). Firm performance is an indicator that helps to evaluate and measure how an organization succeeds in realizing business objectives to all its stakeholders (Antony and Bhattacharyya, 2010). Firm performance refers to a firm's ability to achieve its goal through the application of available resources in an efficient and effective manner (Asat *et al.,* 2015). Studies have used different types of performance indicators to measure firm performance.

For instance, measures such as return on investment, return on sale and return on equity are some of the commonly used parameters to measure performance (Saeidi *et al.,* 2014). Thus, for a more comprehensive assessment, organizations have resorted to the utilization of both financial and non-financial performance measures. Judge *et al.,* (2003) used both financial and non-financial indicators such as process improvements, customer satisfaction, capacity utilization and product service quality to measure firm performance.

The financial performance assessment is devoid of such a multitude of options and methodologies despite critical importance of financial sustainability. Though an ambition for sustainable institutions has been often articulated, there was also an opinion that most financial institutions working in this field have been unsustainable. Research studies have shown that this is predominantly connected to the perception of micro borrowers' risk and creditworthiness, and the diseconomies of scale in making small loans (Quach, 2005).

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.

1.2 Problem Statement

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.

1.3 Research Objective

The objective of the study was to determine the effect of risk identification 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 firefighting 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

Greene and Trieschmann (2004) indicate that risk identification is the first stage of risk management. They assert that correct risk identification ensures risk management effectiveness such that, if risk managers do not succeed in identifying all possible losses or gains that challenge the organization, then these non-identified risks will become non-manageable. The auditor begins the inherent risk evaluation process by generating expectations of accounts balances. The auditor determines how those changes should interact with historic trends to produce an expected balance

in the account and other. The auditor identifies changes that have occurred in the firm or its environment.

Auditors have a role to continuously identify the risks in the organization. Williams *et al.*, (2004) reveals that investigating the problem of risk identification calls for risk identification as a continuous process and continuous seeking of new risk. Risk identification is important as it ensures that the risk management function is established throughout the whole corporation and risk identification helps to sort risk according to their importance. The risk identification assists the management to develop risk management strategy to allocate resources efficiently. By risk identification the organization is able to study activities and places where its resources are exposed to risks.

Al-Tamimi and Al-Mazrooei (2007) say 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. Tchankova (2002) concluded that risk identification is a very important step in risk management. The responsibilities must then be assigned to departments to identify specific risks. In foreign exchange risks, the interest rate risks are the core function of the financial department. Therefore it is vital that the risk management function is firmly entrenched throughout the whole corporation; i.e. the parent company while, the branches to have identify and analyse risks and monitor and control these risks as well. There are various approaches for risk identification, for example, through visualization analysis or risk mapping. An organization will be able to highlight the intensity of risks via risk mapping which could steer the organization away from high and low intensity risks. Risk-ranking is a method of risk identification process that includes components where these rankings are usually based on impact.

Al-Tamimi (2002) discovered that the UAE financial institutions faced credit risks. The study also discovered that follow-up and inspections by branch managers and financial statement analysis were the main methods used in risk identification. Dan (2011) aimed to outline strategies to identify, prioritize, and mitigate risks for the achievement of projects' or organizational objectives and in order to fulfil performance and profitability needs. Risk management helps projects and organizations and at the same time prevents the loss of resources. It provides potentially profitable returns on investments for the organizational management, project management, project stakeholders, and team members. Here help is given as an entity get to where it wants to go and avoid unforeseen circumstances along the way.

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 Descriptive Statistics of Risk identification

The respondent's views on risk identification were sought and their responses presented in table 3. The findings showed that all the statements representing risk identification had a mean score of above 3.83, indicating that the respondents highly rated the variable. The overall skewness was 2.436 and kurtosis was 6.931, indicating that the distribution of values deviates from the mean. From the 10 statements used to explaining risk identification had an overall mean score of 4.013 indicating that respondents agreed on its risk identification measure. This agrees with Greene and Trieschmann (2004) that risk identification is the first stage of risk management. The auditor begins the inherent risk evaluation process by generating expectations of accounts balances. Also concurs with Williams *et al*. (2004) that investigating the problem of risk identification calls for risk identification as a continuous process and continuous seeking of new risk.

Table 3: Descriptive Statistics of Risk identification

	Mean	Std. Deviation	Skewness	Kurtosis
Risk identification is vital for effective risk management	4.3178	1.20489	-1.884	2.413
Through information sharing banks can be able to identify various risk the face in lending to the borrower,	4.1102	.96566	-1.796	3.709
It will help them in the mitigation of the risk through debt collection or credit sanctions	3.9068	1.17772	-1.126	.599
Risk identification is positively significant to influence risk management practices	3.8305	1.0900	-1.010	.545
It is important as it ensures that the risk management function is	4.0466	1.10027	-1.233	.907

established throughout the whole corporation				
Risk identification helps to sort risk according to their importance	4.0720	1.06347	-1.151	.905
Risk identification assists the management to develop risk management strategy to allocate resources efficiently	3.9831	1.17044	-1.380	1.201
Risk inspection is done by managers	3.7839	1.09928	-.880	.272
Roles and responsibilities for risk identification are clearly defined	3.7966	1.15268	-.890	-.017
Risk rating and collateral enhances risk identification	4.0720	1.15183	-1.372	1.188
Mean	**4.0133**	**.79107**	**-2.436**	**6.931**

4.4 Factor Analysis for Risk Identification

The factor analysis results of risk identification, indicated that the KMO was 0.836 and the Bartlett's Test of sphericity was significant ($p<.05$). The Varimax rotated principle component resulted in two factor loading on risk identification variable that explained 51.62 % of variance with Eigen values larger than 1 (table 4).

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

	Component	
	1	2
Risk identification is vital for effective risk management	.757	
Through information sharing banks can be able to identify various risk the face in lending to the borrower,	.819	
It will help them in the mitigation of the risk through debt collection or credit sanctions	.752	
Risk identification is positively significant to influence risk management practices		.752
It is important as it ensures that the risk management function is established throughout the whole corporation	.580	
Risk identification helps to sort risk according to their importance		.621
Risk identification assists the management to develop risk management strategy to allocate resources efficiently		
Risk inspection is done by managers		
Roles and responsibilities for risk identification are clearly defined		.516
Risk rating and collateral enhances risk identification	.544	
Kaiser-Meyer-Olkin Measure of Sampling Adequacy.	.836	
Bartlett's Test of Sphericity (df-45)	.000	
Total Variance Explained	51.623	

Extraction Method: Principal Component Analysis.

Rotation Method: Varimax with Kaiser Normalization.
a. Rotation converged in 3 iterations.

Two statements were deleted; risk identification assists the management to develop risk management strategy to allocate resources efficiently and risk inspection is done by managers. However all the other statements were retained computed and renamed identification for further analysis.

4.5 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 identification) 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.

Table 5: Correlation matrix

	Financial	**Identification**
Performance	1	
Identification	.306**	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

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 identification on performance of financial institutions in Kenya. There was a positive relationship between risk identification and performance of financial institutions [r = .306, p<.05]. From the model the risk identification had no significant relationship (P>0.05) with performance of financial institutions. The null hypothesis **(H_{O1})** that there is no significant effect of risk identification on performance of financial institutions was not rejected. Through risk identification the organization is able to study activities and places where its resources are exposed to risks.

5.2 Conclusions

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

5.2 Recommendations

The study recommends regulators to consider and appropriately legislate risk identification practices to enhance performance of financial institutions.

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