International Journal of Engineering and Management Research
www.ijemr.net
e-ISSN: 2250-0758 | p-ISSN: 2394-6962
Volume- 9, Issue- 4 (August 2019)
https://doi.org/10.31033/ijemr.9.4.18

Relationship between Risk Committee Existence and Financial Performance of Commercial Banks in Kenya

Raymond Kipyegon Kemboi[1], Isaac Kiprotich Naibei[2], Peter Kipkosgei Sirmah[3] and Peter Kimutai Cheruiyot[4]
[1]Student, Department of Finance and Accounting, University of Kabianga, KENYA
[2]Senior Lecturer, Department of Finance and Accounting, University of Kabianga, KENYA
[3]Senior Lecturer, Department of Agroforestry & Rural Development, University of Kabianga, KENYA
[4]Peter Kimutai Cheruiyot, Senior Lecturer, Department of Finance and Accounting, University of Kabianga, KENYA

[1]Corresponding Author: kemraydz@gmail.com

ABSTRACT

Performance of some banks in Kenya has been declining leading to their collapse or receivership. This may be attributed to many factors such as risk exposure. In bid to protect the financial sector, Central Bank of Kenya therefore directed all the banks to manage risks. One of the mechanisms used by the banks to manage risks is risk committee. Some banks established risk committees while others did not. There is limited knowledge on the relationship between this risks committee and financial performance in commercial banks. This study therefore aimed at determining the relationship between risk committee existence and financial performance of commercial banks. The target population was all commercial banks operating in Kenya. The study adopted longitudinal research design that covered a period of five years (2013- 2017). The study used secondary data extracted from annual consolidated and financial reports. Information on specific financial performance indicator was RoA (return on assets) and risk committee existence was extracted from annual reports. Data was analyzed using SPSS by way of regression analysis. The study found that there is a significant positive relationship between risk committee existence and financial performance where the coefficient was r=0.299. The results showed that the model explained 9% (R^2 = 0.09, Adjusted R^2= 0.1084, F (1) = 17.301, p=0.000, p<0.05). This shows that 9 percent in the variations of RoA can be explained by risk committee existence. From the results, it is evident that risk committee existence and RoA have a significant positive relationship. The study recommends that commercial banks should fully implement risk committees in their operations. This will help the commercial banks to manage risk exposure and improve their financial performance.

Keywords-- Financial Performance, Commercial Banks, Risk Management

I. INTRODUCTION

Financial performance is a measure of returns of a bank from its operations over a certain period. It is measured in terms of return on assets and return on equity (Ntuite, 2015). The occurrence of risks and mismanagement directly results to increase or decrease in the financial performance of banks (Wanjohi, Wanjohi, & Ndambiri, 2017). To ensure stability in financial performance, banks need to deal with risks by identifying their various sources. This will require banks to have better information about the current and potential customers and their financial conditions. Banks may need to implement risk governance mechanisms to evaluate money flow and minimize risks that the money is facing (Alshatti, 2015).

According to Kithinji (2010) risk management is the process that commercial banks put in place to prevent its financial exposures. Risk committee is a group of members used by the banks to manage risk exposure. The composition of the risk committee includes members from the board of governance and for some banks; it includes members from the executive. The function of the risk committee is to ensure optimization of assets and liabilities, ensuring compliance with statutory and legal requirements, reviewing and assessing the quality and integrity of risk management. The risk committee also ensure risk policies and strategies are effectively managed (Equity Bank, 2017).

Improper management of risk may result in liquidity risk brought about by the indebtedness of the banks. Commercial banks may collapse if there is poor management of loans or reduction in the quality of the loans advanced to the creditors (Sufi & Qaisar, 2015). While the link between risk and performance is evident in literature, the relationship between risk committee existence and financial performance is not clear owing to limited studies. The risk controls adoption by an institution depends on risk

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decision made at corporate level as per governance structures and mechanisms of different institutions.

II. LITERATURE REVIEW

The major objective of any business as is the case of commercial banks is to maximize the profit level. However, according to Alshatti (2015) there are no banking practices without risk. All the banks face different risks in their operations and therefore it is important for every bank to manage its risks by analyzing and determining corrective action of prevention. In the banking industry, there are internal and external indicators of profit level (Ali, Muhammad, & Hafiz, 2011). The internal indicators may include size of the bank, the efficiency of the operations, capital and credit level, portfolio composition and asset management of the bank. On the other hand, the external indicators may include the factors that cannot be controlled by the banks for example inflation level (Ali *et al*, 2011).

A study by Cheplel (2013) on the impact of enterprise risk management practices on the financial performance of commercial banks in Kenya found out that risk management practices are determined by the extent to which managers understand risk and risk management. The study outlined, enterprise risk management factors such as risk control, self-assessment, compliance of both internal and external regulations, tracking key risk indicators and incident management. This suggests a need to look at other risk management mechanisms to establish the impact of risk management mechanisms on financial performance for example the mechanism of risk committee.

Indeed, according to Kallamu (2015), risk committee that is composed of independent directors, increases firm market valuation and affects accounting returns negatively. The presence of executive in risk management committee has a significant negative relationship with the return on asset (Kallamu, 2015). These observations were done in a developed country Malaysia,therefore, the findings may not be generalized to developing country Kenya.

Makokha (2014) while conducting a study on the effect of corporate governance on financial performance of insurance companies in Kenya observed that corporate governance has an influence on the performance of the insurance companies. The number of the risk management committee had no significant relationship with the performance but the ratio of executive to outside directors did (Makokha, 2014). This study however focused on the insurance companies therefore the findings may not apply to the commercial banks.

Kallamu (2015) found out that the experience of the risk management committee in Malaysia increased both the accounting returns and the market valuation of the company. However, there is need to carry out a similar study using other risk committee attributes, especially now that risk mechanisms adoption by commercial banks in Kenya vary. A study by (Kessey, 2015), observed that the overall role of the risk management lies with the senior management of the banks, hence a need for the credit risk department to be operated by proper trained staff. This therefore justified the need of a study on the impact of existence of risk committee on the financial performance of commercial banks.

Akong'a (2014) found out that there is a significant relationship between the financial risk management and the financial performance in Kenyan commercial banks. Commercial banks should therefore manage such risks in its operations to reduce the impact of losses. However, there is limited knowledge on the relationship between various risk management mechanisms and financial performance (Akong'a,2014). According to Cheplel (2013), commercial banks in Kenya should establish proper communication to build proper confidence in the risk management and enhance risk appetite with the lower level staff.In contrary Han (2015) found that banks in China had weak infrastructure and warning system, which increased the risk faced by the commercial banks. The study recommended that such banks should therefore improve on credit organization structure and establish effective early warning system to minimize the risk exposure. However, in such a case, the risk management department should be independent for effective management of risk (Han, 2015). This responsibility lies with the board committee on risk.

A study by Bhuiyan & Yimei (2013) found that presence of stand alone risk committee enhances the corporate governnace of a company and imroves the financial performance. The data was collected from all the firms in securities industry research centre. Thefindingsof the study by Bhuiyan & Yimei (2013) cannot be generalised to all companies of different sectors. This study will focus specifically to the banking industry in Kenya and the findings will be generalised to the banking industry in Kenya. Another study done by (Elamer & Benyazid (2018) on impact of risk commmittee on financial performance of UK financial institutions found that institutions with existence of risk committee performed poorly compared with institutions that did not have risk committees. This study cincluded that risk committee existence is negatively related to financial perforemnce. The study was doe in UK a developed country with a GDP of 2,828,640 million dollars while Kenya has a GDP of 87,908 million dollars (Countryeconomy.com, 2018). This therefore justifies a need to carry out similar reserch here in Kenya.

III. THEORY

This study was guided by the bank risk management theory that was developed by (Pyle, 1997).

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This theory focuses on the need for commercial banks to manage risks to ensure its survival. Otwori (2013) argues that without an efficient credit risk mangement the banks profitability, the liquidity and solvency are affected negatively (Mwiya, 2010).

In accordance with the banks risk management theory, the commercial banks must reduce the credit risks by utilizing all options available to it including CRB (Credit Reference Bureau) reports. The major sources of credit risks includes wrong credit approaches, poor management and poor credit assessment (Otwori, 2013). When a customer borrows a loan from any financial institution, they should always refund. In some instances, the borrowers in the commercial banks default especially if there is no or less income and this makes the commercial banks to face credit default risks.

Risk management is the identification, appraisal, and prioritization of the risks (explained in ISO 31000) as the impact of uncertainty on goals followed by coordinated and economical use of assets to minimize, screen, and control the likelihood or potentially effect of unfortunate events(Hubbard, 2009). It is important for the banks to give much attention to the sources of credit risk since the credit defaults is the most well-known reason for banks failure, and therefore credit risk management is important for the survival of banks (Alshatti, 2015). It is the duty of lenders to screen out factors that can affect the repayment of loans and to develop ways of minimizing the occurrence of the credit risk.

To eliminate risk, the banks could increase the required securities for giving loans to its borrowers, occasional reassessment and periodical examination of the capacity of clients to generate income to repay their outstanding loan balances to the lenders.There are financial models that creditors can use to analyze default risk, however this model can be manipulated by the staff. This then requires that a bank adopt a risk governance mechanism to oversee the performance and compliance to risk management policies. This risk management mechanism may include the use of risk committees.

IV. METHODOLOGY

The study used longitudinal research design to collect and analyze data for a five-year period (2013-2017). The secondary data was collected from the published consolidated financial statements of the targeted commercial banks. The research focused on all the 42 commercial banks regulated by the Central Bank of Kenya. The research adopted a census of all 42 commercial banks in Kenya. This sampling design was ideal since the population of the commercial banks in Kenya is not large and therefore it could be managed through census.

V. RESULTS

The financial performance of commercial banks in Kenya was based on determining return on assets (RoA). These values were derived from the published annual statements of financial performance for each commercial bank. RoA values were calculated separately for each bank tier by dividing its net profit by the value of the assets used to generate the profit. The findings on RoA for the commercial banks in Kenya for the period 2013 to 2017 are presented in Table1.

Table 1
RoA (Return on Assets) for commercial banks in Kenya (2013-2017)

Tier	2017	2016	2015	2014	2013	Mean
I	3.81	4.57	4.37	5.10	5.29	4.63
II	1.81	0.72	2.65	3.13	3.29	2.32
III	-2.20	1.05	1.75	1.90	2.01	0.90
Mean	**1.14**	**2.11**	**2.92**	**3.38**	**3.53**	

Source: Fielddata, 2019

Generally, tier I banks gave the highest RoA values spread over 2013 to 2017 while tier III banks gave the lowest. This indicates that tier I banks performed better financially compared with tier II and III banks between 2013- 2017. Financial performance of the commercial banks declined between 2013- 2017 as indicated by the decrease in the mean RoA from 3.53 to 1.14 respectively.

Risk Committee Existence in Commercial Banks in Kenya

Data on the existence of risk committee in any one bank was recorded on an arbitrary scale of 1 to 2, where 1 (one) indicated the existence and 2 (two) the absence of a risk committee. Table 2 presents the results of the risk committee existence on tier I to III commercial banks in Kenya for the period 2013-2017 financial years.

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Table 2
Risk Committee existence on Commercial Banks in Kenya

Tier	2017	2016	2015	2014	2013	Mean
I	1.00	1.00	1.11	1.00	1.00	1.02
II	1.00	1.00	1.11	1.00	1.00	1.02
III	1.05	1.06	1.08	1.31	1.18	1.14
Mean	**1.02**	**1.02**	**1.10**	**1.10**	**1.06**	

Source: Field data, 2019 {arbitrary scale1-1.5 (existence) and 1.6-2.0 (absence)}

Generally, all the commercial banks had risk committees in place during the study period of 2013-2017. However, some commercial banks in tier III did not hence pushing the mean arbitrary values towards the 1.6 (table 2) mark suggesting non-existence. Similar trend was observed in tier I and II commercial banks in 2015. These results indicate that most of the commercial banks have adopted risk committees to minimize risk and improve their financial performance. In order to determine the relationship between risk governance existence and financial performance the following hypothesis was tested:

***Ho_1**: There is no significant relationship between risk committee existence and the financial performance of commercial banks in Kenya*

The results are shown in Table 3.

Table 3
Linear regression analysis between Risk Committee existence and ROAs for Commercial Banks

	β	**SEb**	**β**	**T**	
Constant	-0.048	0.579	-		
Main effects					
Risk committee	2.598**	0.625	0.299**		
R					0.299**
R Square				0.09 **	
Adjusted R Square					0.084**
R Square Change					0.090**
Model F Change				17.301	
Model Summary df					1
Sig. F Change					0.000
Durbin Watson				0.848	

Note: Dependent variable, Risk committee
*The significance levels *p<0.05; p**<0.01*

Source: Researchdata, 2019

From the results presented, it is evident that risk committee existence and RoA have a significant positive relationship (r=0.299). The results showed that the model explained 9% (R^2 = 0.09, Adjusted R^2= 0.1084, F (1) = 17.301, p=0.000, p<0.05). This shows that 9 percent in the variations of RoA can be explained by risk committee existence. From the findings also the β of risk committee existence is β = 2.598.From the findings, the null hypothesis is therefore rejected.

The regression equation will be: -

$$Y = -0.048 + 2.598_{RC}$$

Where;

Y - Financial performance indicated by RoA

RC – Risk committee existence

This model shows that the Y-intercept $b_o$is -0.048 hence when there is no risk committee in a bank, the return on assets is -0.048 and for every one-unit change in the risk committee existence, the value of RoA increases by 2.598 units. It can therefore be concluded that risk committee existence contributes to high RoA values and therefore higher financial performance of the commercial banks. Kallamu (2015) observed a significant negative relationship between risk committee existence and RoA in Malaysia. Such observed variation may be due to differences in countries economic situation and GDPs. From the Countryeconomy.com (2018) the GDP for Kenya is 87,908 million dollars and the GDP for UK is 2,828,640 million dollars.

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VI. CONCLUSION AND RECOMMENDATION

The study found a significant positive relationship between risk committee existence and financial performance. This study concludes that risk committee existence is related to financial performance of commercial banks. In regards to the objective of the study to determine relationship between risk committee existence and financial performance of commercial banks, which found a significant positive relationship between the two variables, the study recommends that commercial banks should adopt risk committees. Central bank of Kenya should ensure that all commercial banks establish risk committees. The commercial banks should also train the risk committee members to provide them with skills on risk management. This will enable commercial banks to manage risk exposure and improve on financial performance.

Recommendation for Further Studies

This study focused only on the existence of risk committees in commercial banks in Kenya and its relationship with the financial performance and it is also evident that studies on risk committee has not studied all attributes of risk committee hence the proper standard proportion has not been established. This study therefore recommends that studies can be done on other attributes of risk committee like size, training and expertise.

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