EFFECT OF RISK ANALYSIS ON FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KISII COUNTY, KENYA

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Abstract: **The success of a lending firm is mainly determined by the financial performance in place, governance, professionalism and procedures. Especially to lenders, the minimization of bad loans is beneficial to the entire parties in the loan process. Commercial banks adopt different credit risk management process on financial performance majorly determined by credit scoring systems, banks' ownership of credit policies, caliber of management and banks regulatory environment. Based on the report of the Central Bank of Kenya, there has been a declining performance Kenya's banks between 2012 and 2016. The declining performance has been attributed to credit risk management ineffectiveness in Kenya. Prescriptive initiatives have been placed in position, like guaranteeing that bad loans financing are adequately prepared for, and the least restrictions laid for capital requirements and liquidity appropriateness are adhered to, and yet profit growth has remained low. Therefore, this study sought to investigate the effect of risk analysis on financial performance of commercial banks in Kisii County, Kenya. This study collected data using a descriptive research design while also seeking to derive useful conclusions regarding the report's target population within a specific time frame. The respondents for the study were personnel of commercial banks, specifically those involved in credit allocation. There were 11 executives, one for each of the 11 banking sectors, and 100 credit personnel. The study used a census for management teams and a stratified sampling method for credit staff. In this method, the number of strata in each population is proportional to the total population stratification that was determined from the demographic data. The sample consists of 80 credit department employees from commercial banks. For the primary purpose of this study, closed-ended questionnaires were used. Descriptive statistics included the average and standard deviation. Linear regression was used to examine the relationship between the dependent parameter and the derived explanatory parameters. According to the findings, Commercial banks in Kisii County, Kenya, benefited significantly and positively from risk analysis. The study concluded that errors that are inevitable during the early stages of a commercial bank's financial operations are discovered through the analysis of credit risk. In commercial banks, this creates a level playing field for management goals to be achieved. In the interest of the banks' financial performance, particularly at the branch levels, the study recommends that management of commercial banks optimize the best credit risk identification methods. The banks would be able to reduce the negative impact of credit losses in this way.**

Keywords: **Risk Analysis, Financial Performance.**

1. INTRODUCTION

Commercial banks are institutions established towards rendering nonfinancial and financial management services (Jha, & Hui, 2012). These institutions are established towards rendering services such as funds loaning, customers deposits, foreign exchange trading and stimulation of venture in tools for finance such as stocks (Nazir, 2010). Products rendered through banking institutions that are not financial comprised trustee of valued credentials for customers. These banks render these services in strict compliance with the laws governing the operations and sanity of the corporation and thus, the protection of general interest (Said & Tumin, 2011).

The basic services rendered by these banks are lending. The sum of amounts loaned out by the commercial banks forms their debt portfolios (DeYoung, Gron, Torna, & Winton, 2015). Based on the fact that commercial bank customers are bound by principal and interest obligation at maturity of the loans extended to them, there is a strict requirement for formulators of policies to steadily inspect the market of credit in order to curtail wastages that hampers on speedy economic and monetary development. Loan interest is the major source of commercial banks income. Nonetheless, when issuing out such loans, the banks are confronted with credit risk repayment on the loan is not handy as at when due or principal and interest not paid in general. A few of the dangers that the commercialized banking institutions when extending loans is the hazard of credit which is fluctuatory risk on assets anticpated from loans funds and future incomes (Bessis, 2015).

Credit risk among commercial banks is usually caused adverse selection and moral hazards resulting from information asymmetry between banks and customers (Alkhatib & Harasheh, 2012). It is therefore, crucial to note that the likelihood of a commercial bank insignificantly is determined by the risk of banks’ credit since most of the revenue of banks comes from loan issuance upon which interest is charged (Kithinji, 2010). Nevertheless, banks performance is threatened highly by credit risk. Therefore, the risk associated with credit need to be managed properly (Bhattarai, 2016). For instance, non-performing loans (NPLs) problem has given a lot of attention to economies globally, specifically from the inception of 2007 – 2008 financial meltdowns which argued to be the major cause of banks failure (Klein, 2013). Loan that is non-performing is considered to be that which the due payment dates is overdue within 90 of interest and principal or that which is delayed in agreement or that which offers enough evidence to consider it doubtful for full payment of the principal and interest (Ongore & Kusa, 2013).

Credit management is construed as techniques and adopted strategies by a commercial bank to make sure that it maintains a certain level of credit that is optimal and its management effectiveness. This is the dimension of management finance that involves credit rating, credit analysis credit reporting and credit classification (Weber, Scholz & Michalik, 2010). On the same note, the management of credit is a pre-condition entities that deals with the transaction of credit since it is difficult to have default risk or zero credit. When the amount receivables on accounts are higher and also their age, the cost of finance is highly incurred to sustain them. According to Waweru and Kalani (2009), the management of credit greatly affects other financial institutions and commercial banks success or failure. This is largely attributable to the breakdown of banking industry is largely affected by credit quality decision and thus, the risk of quality assets. Similarly, the management of credit offers an indicator which is leading in banks deposit of credit portfolio quality.

Usually in Nepal, the bank suffers from lending services that are poorly managed. Other suitable and monitoring steps are seen as necessary control measures to moderate the risk associated with lending when it arrives individuals or companies hands (Poudel, 2012). As a result of this, general principle and guidelines have been issued by Nepal Central Bank to govern more detailed implementation of lending practices and processes by the commercial banks. Some criteria are therefore issued by the Central Bank of Nepal which include borrowers credit assessment (firm specific and macro-economic factors analysis), track records, credit purpose, collateral liquidity status for new credit, capacity of repayment as well as existing credit expansion and renewal (Jha, & Hui, 2012).

Afriyie and Akotey (2012) defined the management of credit risk as a well-structured approach used in the management of any unexpected uncertainty via the evaluation of risk and strategies build with the aim of mitigating and management of risk by employing the resources available at the disposal of the banks in Ghana. Management of risk in credit is crucial to the survival of commercialized banking since it an integral part in loan process. Continued profitability of commercial banks depends on an efficiently developed management of credit system for banks stability (Kagoyire & Shukla, 2016). Deteriorating management of credit system is a critical part declining causes of commercial banks finance performances. The policies used in the management of credit include structure of decision making used in curtailing credit asset classification and loan loss provisioning exposures (Tanui, Wanyoike & Ngahu, 2015). This involves the identification, mitigation, measuring, control and monitoring of all credit risk exposures (Raad, 2015).

Credit control system and granting procedure are crucial to the application of loan assessment, which guarantees total loan portfolio of banks in terms of overall integrity (Poudel, 2012). Therefore, the establishment of suitable sound credit processes of granting, credit risk environment, measurement, appropriate credit administration, credit risk control, monitoring strategy and policy that summarize clearly the allocation and scope of banks’ credit structures and the method employed in credit management portfolio i.e. the origination of loans, collection, supervision and appraisal as well as basic elements for effective management of credit risk. Evaluation of negative case likelihood, credit scoring procedures and the attendant losses arising from the migration of negative or default events constitutes fundamental determinants management of credit risk systems (Poudel, 2012).

The evaluation of credit involves the examination of borrowers creditworthiness. This takes into cognizance the repayment sources as well as the member borrowers’ credit history (Lagat, Mugo & Otuya, 2013). This about client assessment to make sure that the borrowers have not only the ability to pay but also the willingness to pay back the loans in due time. This provides a greater understanding of risk which is important in helping an organization in deciding on risk comparison, which allows in the long run prioritization of organizational risk events (Kimoi, Ayuma&Kirui, 2016). In weighing all fronts as regard the hindrance to repayment of loans in the future, there is need to evaluate crtically the borrowers capacity and risk analysis (Bekhet & Eletter, 2014). Monitoring is the last level of credit risk management. This involves the definition of guidelines for the recognition and probably reporting of weaknesses of transactions and credits to make sure they are corrected closely, provisioned and monitored (Makori, 2015). This implies keeping close contact with clients thereby portraying the bank as a problem solver and trusted adviser (Mutua, 2015).

STATEMENT OF THE PROBLEM

The Kenyan commercial banking institutions' performance have been diminishing since 2012 uptil 2016 (CBK, 2016) example of Emperial and National bank. The drop has been attributed to Kenya's inefficient management of credit risks. Stringent strategies have been taken in state, such as making sure that collateralized debt loans are fully accounted for, as well as working to ensure that the required limits established for capitalization and liquidity suitability are performed in accordance to, but notwithstanding the all of this, profit growth has continued to fall as seen with Chase Bank. Amidst the financial services industry's importance to the economic system, numbers have pointed at declining performances of the commercialized banking institutions in Kenya leading to some of them being declared bankrupt and others being put under receivership (Kimathi, & Mungai, 2018). Similarly, pre-tax earnings at grade 3 banking industry fell by 2.2percent from 2015 to 2016. Such drop is explained by the fact that 5 bankers within that area reported deficits.. As experienced in other periods when the commercialized banking institutions in Kenya experienced poor profitability and efficiency, the banking establishments caved in as a consequence of poor administration of risk in credit that are shown by the elevated amounts of nonperforming advances (Central Bank Supervision Report, 2015). In Kenya, the fiscal year closed at 2015, 30th June, saw the Kenya institution of banks registered improved performance by 20% from 3.0 trillion to 3.6 trillion. The sectors overal return on Assets (ROA) decreased to 3.3 percent in 2015. Neverthless Return on Equity (ROE) decreased marginally to 27.4 percent from 28.5 percent in the corresponding period of the year 2015 (CBK monthly economic review)decrease in ROA and ROE expressly links the decrease to the unsatisfactory performance of the loan book as caused by poor credit risk management practices.

2. LITERATURE REVIEW

Theoretical Literature Review

Equity theory was first pioneered by Stouffer in 1977. The theory argued that a reward giving to an individual should be proportionate to what is invested. Relative derivation according to the theory is the reaction to an unbalanced or discrepances experienced in what is peercieved by an individual as actuality and what he percieved as the case, particularly in the even of his own concern. The concept of equity suggests that input-outcome ratio should be constant all over the participating parties in an exchange. As pertain to credit risk management process, equity is percieved as the perception of the borrower where he/she feels that input to outcome ratio is equal to that of the person in exchnage. At risk identification stage, the lending party must identify that when there disparity between expectations and actual performance, the borrower have certain degree of tension which makes adjustment in expectation or in credit risk perception

Gaud, Jani, Hoesli, and Bender (2005) focus on the size of a firm, arguing that large enterprises are heavily indebted because of their size, stability, and less unpredictable cash flows. Additionally, they have a higher chance of profiting from scale advantages that develop once securities are issued on the market. However, during recessionary times when businesses find it difficult to generate adequate cash flow to pay down debt, excessive leverage can be very costly to the organization (Mostafa & Boregowda, 2014). Additionally, because the company's cash flow is restricted, it may not be able to expand its operations, which would result in a stagnant performance. Because they lack collateral for high level debts, smaller businesses might not be able to take on more debt. The trade-off theory is pertinent to this study because it explains that companies below the objective are more likely to use debt financing more frequently, while companies above the target are more likely to use debt financing less frequently. Furthermore, it claims that businesses are more inclined to issue loans when their marginal tax rates are high. because interest payments are tax deductible.

The moderating effect of equity on lending behaviour has been found by studies conducted in such areas. Hope and Player (2012) argued that organizations that are best run and investors smartly invest, sustainability is ensured for what it is considered the driver of strategic separator between the loser and the winner in time to come as reduction of waste and new opportunity in business are all over by lending policies. In this case, organizations that are risk driven stand a better chance of improving the objectives of their business and future performance. Day-to-day life is tied up to lending policies which are customer friendly.

During the lending policy making process, managers ought to obtain information that would warrant them seeing the entire image (Black & Al-Kilani 2013). Black and Al-Kilani (2013) posited that, in the event of creating unique decision, its critical towards collate details that relate particularly to the matter. Data upon true cost as well as relevant costs should be considered. Data that is forward-looking could be of great significance, nonetheless, the availability of the data may at some certain point in time be a constraint factor. The theory is relevant as it applied to credit risk analysis during lending. Whenever predictions as well as the authentic occurrences may never tally, three is going to have some risk extent of pressure. To alleviate such a pressure, be it preconceptions or notions of the company's overall results must be adjusted.

Empirical Literature Review

The assessment of risk analysis effect on SACCOs performance was performed by Dhakal (2011); where it noted which risk management is not rooted towards institutional cultures of SACCOs and all values are not shared by all employees. Given the capacity as noted by him, the introduction of technical tools and sophisticated systems in managing risk fails to operate in SACCOs, however this ability is necessary for managing risk is lacking.

Gaitho (2010) conducted a survey on loan risk assessment techniques in Nairobi. It was discovered that the Managing credit risks was utilized by the greater part of saccos processes to reduce risk factors as the grounds for risk in credit evaluation impartiality. Besides that, most SACCOs leaned entirely on investments management staff' potential as well as discernment for efficient credit risk management processes rather than a structure that streamlines credit-related and credit-related risk choices.

Owusu (2008) examined the effect on creditworthiness strategies in Ghanaian urbanized banking institutions. It was revealed that credit application appraisal did not sufficiently assess the inherent risk of credit to provide guidelines on suitable credit risk in guiding appropriate credit decision. Additionally, it was found that the two banks drafted credit policy documents lacked the essential for basic credit management such as credit portfolio mix, credit delivery process, management of problem loans, basis of pricing and so on to sufficiently ensure they are robust. He advocated that an amount credit should be assessed carefully for project identification to ensure adequate funding.

Using microfinance institutions, Githingi (2010) explored the efficiency of operating risk and the indicators of loan portfolio. The outcome suggested that majority of the MFIs use operating efficiency to a greater extent as a indicators of credit risk management practice. Productivity and efficiency ratios are employed to determine the effectiveness of microfinance institutions in streamlining their credit operations. Notably, the banks need to employ a mixture of performance indicators to include portfolio quality, operating efficiency and profitability indicators to assess their overall performance.

3. RESEARCH METHODOLOGY

This study collected data using a descriptive research design while also seeking to derive useful conclusions regarding the report's target population within a specific time frame. The respondents for the study were personnel of commercial banks, specifically those involved in credit allocation. There were 11 executives, one for each of the 11 banking sectors, and 100 credit personnel. The study used a census for management teams and a stratified sampling method for credit staff. In this method, the number of strata in each population is proportional to the total population stratification that was determined from the demographic data. The sample consists of 80 credit department employees from commercial banks. For the primary purpose of this study, closed-ended questionnaires were used. Descriptive statistics included the average and standard deviation. Linear regression was used to examine the relationship between the dependent parameter and the derived explanatory parameters.

4. FINDINGS

The descriptive statistics results of risk analysis are presented in Table 1.

Table 1: Risk Analysis

Statement	N	Percentage					Mean	Std. Deviation
		1	2	3	4	5		
Banking firms strictly observes the credit terms before approving credit	70	42.5	22.5	5	15	15	3.7445	.8632
The bank relaxes credit approval terms for clientele who make on-time loan payments.	70	30	25	17.5	15	12.5	4.1324	.6734
Credit approval prioritizes risk assessment.	70	37.5	30	7.5	12.5	12.5	3.9763	.5326
The bank's risk management regulation accomplishes its goal.	70	30	27.5	7.5	17.5	17.5	4.2345	.7532
Banking establishments can knows their good customers	70	30	37.5	12.5	12.5	7.5	4.0877	.98389
The Bank always relies on previous record in approving the loan	70	17.5	27.5	30	7.5	17.5	4.5614	.56750
Average Score	**70**						**4.0219**	**0.7056**

The survey findings demonstrated that the respondents strongly approved on the establishments precisely observes the credit conditions prior to approval credit. The position aligned with the outcome of the mean and standard deviation of the study as indicated by 3.7445 and 0.8632 values. The organization loosens borrowing authorization conditions for customers who make on-time borrowing payments as a statement to evaluate the banks risk analysis was agreed upon by the respondents given the average as well as standard deviation of 4.1324 and 0.6734 correspondingly. Its assertion regarding as to if vulnerability appraisal is a primary concern in loan approval was agreed upon by most of the survey participants. This is indicated by the means and standard deviation values of 3.9763 and 0.5326. With regard to if the institution's strategy for vulnerability coordination is effective, respondents agreed that such statement validate that risk analysis is key in commercial banks financial performances as observed mostly by average value of 4.2345 as well as the standard deviation of 0.7532. The bank can recognize your good customers' had been decided on through the respondents as indicated by the average as well as standard deviations values of 4.0877 and 0.56750 correspondingly. Furthermore, as indicated by several survey participants, the financial institution invariably tends to rely on prior file in authorizing the loan by the average mean of 4.5614 and standard deviation of 0.56750. The composite values of the Standard deviation and mean values of the respondents report on the role of risk analysis in commercial banks financial performance is noted by 4.0219 and 0.7056 values. The findings support the study of Githingi (2010) who concluded that majority of the MFIs use operating efficiency to a greater extent as a indicators of credit risk management practice. Therefore, the use of operational efficiency proportions to determine the effectiveness of microfinance institutions in streamlining their credit operations.

Results of Regression Analysis

Table 2: Model Summary

Model	R	R Square	Adjusted R Square
1	.876^{a}	.786	.735

The R value of this indicator shows that there is a strong linkage amongst credit risk identification methods and commercialized banking establishments finance performances as shown by the value of 0.876. The R-square indicates that the credit risk identification methods of commercial banks in Kisii county of Kenya were mainly responsible for only 78.6% of the changes in their financial performance. The explanation for the variation in commercial banks' financial performance in Kenya is that the indicators of risk analysis explained the variation in their financial performance. This means that the risk analysis of these commercial banks affected the results of their financial performance in Kisii, Kenya.

Table 3: Analysis of Variance

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	19.072	1	19.072	49.409	.000^{b}
	Residual	26.246	68	.386		
	Total	45.318	69			

The output of variance assessment is shown in Table 3. It shows the significance of the overall model. The F statistical value of 49.409 was obtained. It was statistically significant. This means that risk analysis has substantial effect on the financial performance of commercial banks in Kisii County, Kenya.

Table 4: Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	.049	.057		0.864	.396
	Risk Analysis	.052	.023	.057	2.242	.035

The effects of various explanatory variables on financial performance of commercial banks are shown in Table 4. The coefficient of positive financial performance and the probability of 0.396 indicate that commercial banks' financial performance would be insignificant in the absence of risk analysis.

The findings shows which of the risk analysis has a substantial favorable effects on Kisii commercialized banking institutions financial performances. It shows that a 1% rise in risk analysis would steer to an increase in the banks' financial performances by 0.052%. The outcome of the study could be accredited to the critical analysis carried out by these banks with respect to customers' transaction history which has significantly affected the banks level of financial performance with the Kisii county region. The findings and recommendations of this study is at variance with Owusu (2008) who revealed that credit application appraisal did not sufficiently assess the inherent risk of credit to provide guidelines on suitable credit risk in guiding appropriate credit decision. Additionally, it was found that the two banks drafted credit policy documents lacked the essential for basic credit management such as credit portfolio mix, credit delivery process, management of problem loans, basis of pricing and so on to sufficiently ensure they are robust. The disparity in the outcomes could well be linked to the various zones where the surveys had been carried out.

5. CONCLUSIONS

Risk analysis has favourable as well as substantial effects on Kenya's commercial banks' branches financial performance in Kisii County. In conclusion, the analysis of credit risk uncovers mistakes that are bound to occur at the early stage of commercial banks financial operations. This provides level playing grounds for the achievement of management goals in the commercial banks.

6. RECOMMENDATIONS

The administration of the banks should implement wider risk analysis policies that would help in assessing the viability and feasibility of loans recovery processes by customers. This would reduce the chances of loan losses thereby increasing the chances of financial performance of commercial banks in Kisii County, Kenya.

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