Efficient Risk Management and the Bank Performance

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ABSTRACT

The recent financial crisis and scandal such as Enron have raised several questions with respect to the growing awareness and the need for appropriate Risk Management of financial institutions. The risk management issues in the banking sector have greater impact not only on bank performance but also on national economic growth, the bank's motivation for risk management comes from those risks which can lead to the poor performance. This study aimed at focusing on the association of risk management practices and finance performance in Bank of Kigali Ltd. This study also intended to investigate whether efficient risk management translate into enhanced performance of bank. Documentary technique was used to collect secondary data which was on two years progressive, these data from financial statements and annual report of 2014, 2015 were processed discussed and analyzed and revealed that by the efficient practice of the five types of risks inherent in Bank of Kigali (credit risk, liquidity risk, foreign exchange, interest risk, capital management risk.) have a positive impact on its financial performance with ROA and ROE of 3.9% and 21.7% respectively. The bank's net profit of FRw 20.5 billion with the net interest income of 46.2 billion with the income ratio of 47.8%. the loan book grew of 34.5% on year the increasing deposits on the other banks of 384.7 billion and the liquidity assets in the form of placements with correspondent bank increased significantly to FRw 39.2 billion.

Key words: Risk Management, Bank Performance.

Introduction

Risk management evolved from a strictly banking activity, related to the quality of loans, to a very complex set of procedures and instruments in the modern financial environment. It underscores the fact that the survival of an organization depends heavily on its capabilities to anticipate and prepare for the change rather than just waiting for the change and react to it. Risk is associated with uncertainty and reflected by way of charge on the fundamental /basic i.e. in the case of business it is the capital, which is the cushion that protects the liability holders of an

institution. These risks are interdependent and events affecting one area can have ramifications and penetrations for a range of other categories of risk.

There is therefore, the need to understand the risks run by banks and to ensure that the risks are properly confronted, effectively controlled and rightly managed. Each transaction that a bank undertakes however changes the risk profile of the bank thereby making it a near impossibility to provide real time risk update and profile of the institution.

Risk Management (RM) is described as the performance of activities designed to minimize the negative impact (cost) of uncertainty (risk) regarding possible losses (Schmidt and Roth, 1990). Redja (1998) also defines risk management as a systematic process for the identification, evaluation of pure loss exposure faced by an organization or an individual, and for the selection and implementation of the most appropriate techniques for treating such exposures.

The process involves the identification, measurement, and management of the risks. Bessis (2010) also adds that in addition to it being a process, risk management also involves a set of tools and models for measuring and controlling risk. The objectives of risk management include the minimization of foreign exchange losses, reduction of the volatility of cash flows, protection of earnings fluctuations, increment in profitability and assurance of survival of the firm (Fatemi and Glaum, 2000).

Another group of researchers stated that RM is about ensuring that risks are taken consciously with full knowledge, clear purpose and understanding so that it can be measured and mitigated to prevent a firm from suffering unacceptable loss causing it to fail or materially damage its competitive position.

To ensure that banks operate in a sound risk management environment with reduced impact of uncertainty and potential losses, managers need reliable risk measures to direct capital to activities with the best risk/reward ratios. Management needs estimates of the size of potential losses to stay within limits set through careful internal considerations and by regulators.

They also need mechanisms to monitor positions and create incentives for prudent risk taking by divisions and individuals. According to Pyle (1997), risk management is the process by which managers satisfy these needs by identifying key risks, obtaining consistent, understandable, operational risk measures, choosing which

risks to reduce, which to increase and by what means, and establishing procedures to monitor resulting risk positions.

Bessis (2010) indicates that the goal of risk management is to measure risks in order to monitor and control them, and also enable it to serve other important functions in a bank in addition to its direct financial function.

These include assisting in the implementation of the bank's ultimate strategy by providing it with a better view of the future and therefore defining appropriate business policy and assisting in developing competitive advantages through the calculation of appropriate pricing and the formulation of other differentiation strategies based on customers' risk profiles.

According to Santomero (1995), the management of the banking firm relies on a sequence of steps to implement a risk management system. These normally contain four parts which are standards and reports, position limits or rules, investment guidelines or strategies and incentive contracts and compensation. These tools are generally established to measure exposure, define procedures to manage these exposures, limit individual positions to acceptable levels, and encourage decision makers to manage risk in a manner that is consistent with the firm's goals and objectives.

The main objective of risk management remains the maximization of shareholder's value (Beasley et al., 2008; CAS, 2003; COSO, 2004. According to Hoyt and Liebenberg (2011), profit maximizing firms should consider the implementation of ERM program if it guarantees increases in expected shareholder value. Risk management has gone through a narrow view that evaluates risk from a Silo perspective to a holistic all-encompassing view (Beasley et al., 2005; Tufano 1996). Sustainable performance in BK can be only achieved through disciplined risk management. It is a part of our corporate culture that every employee at every level of the organization is accountable for risk management.

It would be recalled that in the 1980s and 1990s, many leading banks around the world declared hug annual losses resulting from primary (especially credit) risks mismanagement; but, most of those who survived without the need for external support was because their capital cushion was adequate. This means that their solvency risk management was good.

The issue here is that other primary risks inherent in banks operation may occasion the unexpected losses but the level of solvency protection obviously determines the survival of the bank. Solvency is therefore not an irrelevant risk category. It was said that Walter Bagehor, the 19th century banker, journalist and political commentator once said that "a well managed bank need no capital, with the 1st no amount of capital can save an ill managed bank" (Cade, 1999).

This could not be entirely true but there could be grains of truth in some of the phrases used. In the first place, how well managed, how ill managed, what about all the intermediate conditions? It is undisputable that adequate management of a bank especially the inherent risk is important, but it cannot be all, and moreover who guarantees the quality of its management. Although the management of banks may change, the structure and processes in place may help to prolong the status of the management. A bank's management may be good in one decade and in another bad because of certain wrong decisions taken at onetime that pull down its resources. With all these in mind, the place of adequate capital in banks operation cannot be dismissed. Capital is as important as risk capital is in business generally.

Materials and Methods

Data for this study was secondary in nature and was gathered mainly from the annual reports of Banque de Kigali. Each of the risk management areas (credit risk, liquidity risk, operational risk and market risk) as practiced by the selected bank are gotten through appropriate ratio computation using figure as contained in the financial statements. Each category of the risk management practices represents areas as suggested in Basel II. This serves as the guide of conducting the content analysis. This is contrary to studies that uses questionnaire which is distributed to target respondents as the means of gathering practices of risk management (Ariffin and Kassim, 2009).

The researcher considers this method as adequate and appropriate, especially, in the light of the Chosen consecutive years 2014-2015, this annualreports disclose more information inclusive of risk management practices. In addition, the financial performances (ROA and ROE) are also presented alongside. As contained in the financial statements. Each category of the risk management practices represents areas as suggested in Basel II. This serves as the

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Secondary data from financial statements of Banque de Kigali was collected. The study collected secondary data for the last consecutive years 2014-2015. Data analysis was done using SPSS Version 20 whereby inferential statistics was applied whereby a multiple regression model was employed. To test the relationship between effective risk management and financial performance of Banque de Kigali, a logic regression model was used:

$Y = \alpha + \beta 1X1 + \beta 2X2$------------------- $+ \varepsilon$ (1)

The Y is a dependent variable and refers to the return on assets (ROA) of BK; X1represents the independent variable which is financial risk management, whereas X2 represents the other determinants of a financial performance; β is a co-efficient.

Analytical Model

The empirical model used in the study to test the relationship between financial risk management and financial performance of Banque de Kigali is presented as follows:

$Y=\alpha+\beta 1X1+\beta 2X2+$
$X3+\beta 4X4+\beta 5X5+\beta 6X6+\beta 7X7+ \varepsilon$ (2)

Where:

Y: financial performance as measured by return on assets (ROA).

α is the intercept

ε represent the error term

X1: is the credit risk for the bank, credit risk for the bank was measured using the level of non-performing loans which was the ratio of non-performing loans to total loans and advance.

X2 : is the interest rate risk for the bank, interest rate risk for the bank was measured using the ratio of the interest rate sensitivity gap between assets and liabilities maturing within a period less or equal to one year to total assets.

X3: is the foreign exchange risk for the banks, foreign exchange risk was measured using the ratio of net foreign currency exposure between assets and liabilities to total assets.

X4: is the liquidity risk, liquidity of the bank was measured using the banks liquidity ratio,

which will be the ratio of total loans to total deposit.

X5: is the capital management risk of the bank, capital management risk was measured using the ration of capital and reserve to total assets.

X6: is the bank's deposits which was measured using the ratio of deposits to total assets.

X7: is the banks size which was measured using the natural log of total deposits.

3. Results and Discussions

The practice of risk management in bank of Kigali

The findings from this study are supported by its similar conducted by Mrs . Kishori . B and Jeslin Sheeba about the impact of credit Risk on the profitability of bank by identifying that Capital Adequacy Ratio (CAR), Leverage Ratio and Liquidity Coverage Ratio (LCR), Nonperforming Asset Ratio (NPA), Loan to Deposit Ratio (LDR), Cost per Loan Ratio (CLR), were as the indicators of Credit risk and ROE and ROA and revealed that the credit risk affect the profitability of the bank.

Another study conducted by Adeusi, Stephen Oluwafemi Ph.D, Akeke, Niyi Israel, Adebisi, Obawale Simeon, Oladunjoye, Olawale which revealed that there is a relationship between risk management and financial performance of 14 banks of Nigeria IOSR Journal of Business and Management (IOSR-JBM) e-ISSN: 2278-487X, p-ISSN: 2319-7668. They concluded by saying that there is a significant relationship between bank performance and effective risk management. Better risk management in terms of managed fund, thus, it is of crucial importance that banks practice prudent risk management and safeguarding the assets of the banks and protect the investors' interests.

The activities of Bank of Kigali also expose it to a variety of financial risks including credit risk, liquidity risk, foreign exchange risks, interest risk capital management risk. The Bank's overall risk management program focuses on the unpredictability of financial markets and seeks to minimize potential adverse effects on the Bank's financial performance.

According to Dr Diane Karusisi in his Executive Officer's report of 2015 Sustainable performance in BK can be only achieved through disciplined risk management. It is a part of our corporate culture that every employee at every level of the organization is accountable for risk management, and this approach has enabled the bank to overcome the challenges of

changing global, regional and domestic macroeconomic environment inherently.

Risk management policies and systems are reviewed on regular basis to reflect changes in market conditions, products and services offered. The Bank's risk management policies are established to identify and analyze the risks faced by the bank, to set appropriate risk limits and controls and to monitor risks and adherence to limits.

Credit risk

Credit risk is the risk of financial loss to the bank if a customer or counterparty to a financial instrument fails to meet its contractual obligations and arises principally from the Bank's loans and advances to customers. In this the Bank of Kigali considers and consolidates all elements of credit risk exposure. The credit committee is responsible for over sighting the bank's credit risk by formulating credit policies in consultation with business units, covering collateral requirements, credits assessment, risk grading and reporting.

Credit risk is the single most important risk facing banks. That is the reason why Bank of Kigali continue to manage credit risk and make sufficient provision for any specific risk proactively, it is in this regards that the non- performing loans risk coverage was 110.2% compared to the market average of 46.2%.

The market has continued to benefit from the reforms that have been made both in regulatory framework as well as the land registry. And this helped the bank the fast tracking of provision of titles deeds and foreclosure with the aid of electronic registration of collateral as an important tool in credit risk management.

Liquidity risk

Liquidity risk is the risk that the bank will encounter difficulty in meeting obligations from its financial liabilities.

The Bank's approach as far as possible that it will always have sufficient liquidity to meet liabilities when due, under both normal and conditions, without incurring unacceptable losses or risking damage to the bank's reputation.

The Bank's treasury maintains a portfolio of short-term of short- term risk investment under a variety of scenarios covering both normal and more severe market conditions.

The key measure used by the Bank for managing liquidity risk is the ratio of net liquid assets to deposits from customers.

Details of reported Bank's ratio of net liquid assets to reporting date and during the reporting year were as follows:

Credit risk measurement

This practice is used when the Bank is assessing the probability of default of a customer or counterpart using internal rating scale tailored to the various categories of counter party. This reflects the range of default probabilities for each rating class.

According to the policies of Bank of Kigali the internal rating scale is as follows:

Grade1: Normal Risk (between 0-30 days)

Grade 2: Watch risk (between 31-90 days)

Grade 3: Sub-standard risk (between 91-180 days)

Grade 4: Doubtful risk: (between 181-360 days

Grade 5: Loss (over 360 days).

Bank of Kigali to handle this issue has established an allowance for impairment and provision losses that represents its estimate of incurred losses in its loans and advances portfolio.

The mandate of the Risk Management Committee is to ensure that the Bank's enterprise risk management policies and procedures are updated to ensure that the risks are properly tackled, effectively controlled and managed. This Committee comprises of three non-executive board

	2015	2014
At close of the year:	53.0%	64.9%
Average for the year:	56.7%	67.8%
Maximum for the year:	63.6%	70.3%
Minimum for the year:	50.5%	64.9%

members and meets on quarterly basis or more frequently as its business demands.

Market Risk Currency risk (Foreign exchange risk)

The Bank takes on exposure to effects of fluctuations in the prevailing foreign currency exchange rates on its financial position and cash flows. The Board sets limits on the level of exposure by currency and in total for both overnight and intra-day positions which are monitored daily and hedging strategies used to ensure that positions are maintained within the established limits.

Transactions in foreign currency are recorded at the rate in effect at the date of the transaction. The Bank translates monetary assets and liabilities denominated in foreign currencies at the rate of exchange in effect at the reporting date. The Bank records all gains or losses on changes in currency exchange rates in profit or loss.

Operational risk (capital management risk)

Operational risk is the risk of direct or indirect loss arising from a wide variety of causes associated with the Bank's processes, personnel, technology and infrastructure and from external factors other than credit, market and liquidity risks such as those arising from legal and regulatory requirements and generally accepted standards of corporate behaviour. Operational risks arise from all of the Bank's operations and are faced by all business units.

The Bank's objective is to manage operational risk so as to balance the avoidance of financial losses and damage to the Bank's reputation with overall cost effectiveness and to avoid control procedures that restrict initiative and creativity.

The primary responsibility for the development and implementation of controls to address operational risk is assigned to senior management within each business unit. This responsibility is supported by the development of overall Bank standards for the management of operational risk in the following areas:

Requirements for appropriate segregation of duties, including the independent authorization of transactions.

Requirements for the reconciliation and monitoring of transactions.

Compliance with regulatory and other legal requirements. Documentation of controls and procedures. Requirements for the yearly assessment of operational risks faced and the adequacy of controls and procedures to address the risks identified.

Requirements for the reporting of operational losses and proposed remedial action.

Development of contingency plans. Training and professional development Ethical and business standards. Risk mitigation, including insurance where this is effective. Compliance with Bank's standards is supported Internal audit and risk compliance department. The result management of the business unit to which they relate.

Bank of Kigali Performance

The Bank's net profit grew by 11.7% to FRw 20.5 billion in 2015 up from FRw 18.3 billion realized in 2014. The increase in profitability was mainly driven by a 17.8% growth in net interest income amounting to FRw 46.2 billion. Our cost to income ratio was 47.8% in 2015, an improvement over the last year 2014 in spite of the expansion of the Bank's branch network and other infrastructure. The strong performance

accounts for over 50% of the total commercial banking sector profits.

The Bank was able to sustain the growth in the balance sheet by 16.3% to FRw 561.2 billion. The loan book grew to FRw 313.9 billion from FRw 233.4 billion, a growth of 34.5% year on year. Deposits on the other hand were FRw 384.7 billion up from FRw 324.6 billion in 2014. Our liquid assets in the form of placements with correspondent banks increased significantly to FRw 39.2 billion.

The consolidated financial statements of revealed that the fiscal year of 2015 was a highly successful for the Bank of Kigali and for its shareholders. The financial performance showed a strong net income of Rwfrs 20.5 billion, the total assets grew 16.3% year on year and the shareholders' equity grew by 10.8%, the high profitability remained intact, with ROA and ROE of 3.9% and 21.7% respectively. (Source: Annual report 2015 BK)

Suggestion for the future research.

Based on the previous research, we used some ratios to represent the five types of risks and used ROE and ROA as performance indicators, we would like to recommend to other researchers to include others risks and other aspects of bank performance to test the relationship between those variables in the future.

Conclusion

This study shows that when there is an efficient practice of risk management (credit risk, liquidity risk, market risk, operational risk and solvency risk} in banking sector, this contributes to its financial performance. Better risk management in terms of managed fund, reduction in cost of bad and doubt loans and debt equity ratio results in better bank performance, which makes an increasing of Net profit, Net interest income, and reasonable income ratio, ROE and ROA

Thus, it is of crucial importance that banks practice prudent risk management so that it can maximize the profit and protect the investors' interests.

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