Relationship between risk management and financial performance: empirical evidence from microfinance banks in Kenya

The microfinance banking subsector in Kenya has been faced with risk management challenges. This necessitated the adoption of the Risk Based Supervision approach of supervising Microfinance banks in 2010. Additionally CIS feature was extended to MFBs to check on credit default. Despite these efforts, the level of profitability and sustainability of the sector dropped significantly with ROE and ROA reported at 8% and 1% respectively. Non-performing loans increased by 6.9 percent and Risk coverage ratio shows a worrying negative trend. The operating costs and interests have remained high and in terms of solvency position, the microfinance sector shows a decreasing trend of capital adequacy ratio dropping from 22.8% as of Dec 2009 to 18.9% in 2013. Hence the major objective for this study was to establish the relationship between risk management and financial performance of Microfinance banks in Kenya. Specific objectives were: to determine the degree of relationship between credit risk management and financial performance of MFBs; to establish the degree of relationship between liquidity risk and financial performance of MFBs and determine the degree of relationship between operational risk and financial performance of MFBs in Kenya. Correlational research design was adopted. Target population comprised six MFBs that were in operation during the year 2011 to 2015. This was a census study and document analysis guide was used to gather secondary quantitative data from the MFBs financial reports while interview schedule was used to gather primary data from Credit, Finance and Operation managers of the MFBs. Descriptive statistics were used to show the trend of MFB risk exposure and performance. Pearson correlation was used to determine strength and association among variables. Panel data analysis based on system GMM technique was used to estimate a multiple regression model and test for significance of relationship between Risk management and financial performance. The findings were that Credit risk management with PAR and LLPCR parameters had a strong negative correlation ($r=-0.68$), giving a significant negative relationship with both ROAA and ROAE performance measures as depicted by regression coefficient of -0.2 estimated by GMM. Liquidity risk management proxied by FGR and CAR had moderate positive correlation ($r= 0.45$), giving a significant positive relationship with performance estimated by a regression coefficient of 0.3. Operational risk management with CIR and OVR, showed a weak but negative significant correlation ($r = -0.2$), also giving a significant relationship with ROAE. Thus, the study concluded the existence of a significant relationship between risk management and performance and that credit and liquidity risk management impacts financial performance of MFBs. The study recommended that Credit managers should operate under a sound credit granting process with a thorough understanding of the borrower, purpose & structure of the credit, and its source of repayment. The finance manager should embrace robust framework for comprehensively projecting cash flows arising from assets, liabilities and off-balance sheet items. Additionally, CBK should tighten its supervisory role in maintaining prudential ratios. For further research, this study could be expanded to cover longer time period and include MFBs recently established. Other econometric analysis methods and econometric factors can be adopted.