Credit Risk Management and Bank Performance Case Study Commercial Banks in Mogadishu Somalia

Anab Ali Farah

Abstract: ***The theme was about the Credit Risk Management and Bank Performance; Three research objectives guided the work.They are: 1) To determine the effect of a credit appraisal process in the financial operation of selected commercial bank in Mogadishu-Somalia.2) To examine the issue of lending requirements on the fiscal operation of selected commercial bank in Mogadishu-Somalia.3) To establish the effect of the monitoring process on the financial operation of selected commercial bank in Mogadishu-Somalia.The research purpose was a quantitative and qualitative survey descriptive research design.Information was collected through quantitative method.A questionnaire was employed to gather data from sample size 67 of the respondents.The data were collected using frequency table, and SPSS version 16.0 was used to examine the information.This survey will be essential for Banks, and also the study will be useful to potential researchers as literature, which is interesting to bear out for further research in this area.After background information has been called for the respondents, the researchers went ahead to deliver the findings are following: - Based on the findings in objective one presented that To determine the result of credit appraisal process on the financial operation of selected commercial bank in Mogadishu-Somalia scored Average mean 4.26overall and this outcome indicates that the overall of objectives was Excellence.Established on the findings in objective two presented that To examine the issue of lending requirements on the fiscal operation of selected commercial bank in Mogadishu-Somaliascored Average mean 4.43 overall and this outcome indicates that the overall of objectives was Excellence.Established on the findings in objective three presented that To establish the effect of the monitoring process on the financial operation of selected commercial bank in Mogadishu-Somalia scored Average mean 4.43 overall and this outcome indicates that the overall of objectives was Excellence.Established along the findings presented that Commercial Bank Performance (DV) scored Average mean 3.3 overall and this result indicate that the overall of objectives was good.The effect of correlation analyzes the relationship between Credit Risk Management and Bank Performance. The Result indicates that Credit Risk Management has positive correlate on Bank Performance with beta value 0.815. That stands for the correlate between variables is 81.5% of beta value, this outcome is a high positive correlate among variables.The researcher recommends that the commercial banks should also try to maintain their operational cost low as this negates their profit margin thus leading to low financial performance.This is drawn by the substantial effect of net income on financial performance.***

Keywords: A credit risk, Credit risk management*, Bank performance, Credit* appraisal*, Lending requirement, Credit monitoring.*

1. Introduction

Banks act as a major part in all the economic and financial activities in advanced social club.One of the core activities of the banking industry worldwide and, in particular Mogadishu-Somalia, is the universe of credit to deserving and deficit units of the economy.Credit institution is the primary income generating activity for the banks but this natural process involves huge risks to both the lender and the borrower.Banks are open to a wide array of risks in the course of their operations and generally banking risks fall into three categories: financial, operational, and environmental risks (Greuning&Bratanovic, 2009).The hazard of a trading partner not fulfilling his or her responsibility as per the contract on due date or any time thereafter can greatly endanger the smooth operation of a bank‘s job. On the other hand, a bank with high credit risk has highest bankruptcy risk that puts the depositors in jeopardy. Among the risk that force banks, credit risk is one of big fear to most bank authorities and banking regulators.This is because credit risk is one peril that can easily and most likely prompts bank failure (Getenet Arega, 2014).

The financial services offered by banks are indispensable to economic and financial growth.Their function as financial intermediaries facilitates rapid economic development. Financial stability is critical for any country so therefore the financial institutions require to be properly handled. The velocity of loan creation in an economy significantly influences the productive activities in a country.The main motive of a depository financial institution is to redirect funds from the surplus sector to the deficit sector in a profitable and sustainable way.Interest on loans and improvements are the principal roots of income for a commercial bank, by handing out loans, banks are exposed to different sorts of dangers, e.g. liquidity risk, credit risk, etc. (Kargi, 2011).

Our primary focal point is the credit risk a bank incurs by virtue of loan origination.The Basel Committee on Banking Supervision (BCBS) defined credit risk as the chance that a bank borrower will fail to fulfill its responsibilities in conformity with agreed terms or the possibility of losing the outstanding loan partially or wholly due to recognition events (Iwedi, &Onuegbu, (2014). Poor credit administration reduces bank profitability and leads to bank distress and/or failure (Osaka, &Amako, (2015). The purpose of credit risk management is to maximize a bank's risk adjusted rate of recurrence.This can be accomplished by maintaining credit risk exposure within acceptable parameters.Efficient loan portfolio diversification can ensure that credit risk is minimized but it is imperative for banks being wary of credit risk in dealing out each individual loan (Taiwo JN1, 2017).

Credit risk management is a structured approach to managing uncertainties through risk assessment, developing strategies to handle it, and mitigation of risk using managerial resources.The strategies include transferring to some other party, keeping off the risk, thinning out the negative effects of the danger, and accepting some or all of the results of a peculiar peril.Close to traditional risk managements focused on risk stemming from physical or legal reasons (such as natural disasters or fires, chance events, deaths and cases).Financial risk management on the other hand, concentrates on risks that can be got by using traded financial instruments.The aim of risk management is to dilute the effects of dissimilar sorts of risks linked to a preselected domain to the level accepted by company.It may refer to numerous cases of threats caused by environment, technology, humans, organizations and government. On the other hand it involves all means available for humans, or, in particular, for a risk management entity (person, staff, organization). This dissertation adopts a firm look on Banking and Credit risk management and further investigations into bank risk exposure, assessment, management and mastery.An effort will be made to unfold the purpose of some risk management, valuation and assessment tools, examples, and techniques (Iwedi, & Onuegbu, (2014).

The primary aim of this work was examined “Credit Risk Management and Bank Performance commercial banks in Mogadishu Somalia.The survey tried to accomplish the following specific objectives: to determine the result of credit appraisal process on the financial operation of selected commercial bank in Mogadishu-Somalia, to analyze the issue of lending requirements on the fiscal operation of selected commercial bank in Mogadishu-Somalia, to establish the effect of the monitoring process on the financial operation of selected commercial bank in Mogadishu-Somalia.

2. Literature Review

In economics, the loan able funds doctrine is a theory of the market interest rate, which owes its inception to the Swedish economist Knut Wicksell.Agreeing to this approach, the interest rate is regulated by the demand for and supply of loanable funds which is a prerequisite component in the evaluation of credit requirements in the economy. The interest rate is the risk premium that the borrower pays to acquire credit hence affect the need for loan able funds in our current study (Gyntelberg et al, 2007).

The financial intermediation theory is founded on the theory of informational asymmetry and the representation theory.The advance of financial intermediaries is based along the method of regularization of the monetary creation, of saving and financing of economic. The method of regulation influences the liquidity and solvability of intermediaries (Gurley & Shaw, 1960).

Rajan (2010) indicate that the rules regarding the capital of intermediaries influence their health, the ability for refinancing and the method for recovering debts. Furthermore, because financial institutions are able to break down assets into small units, they can cut transaction costs and also employ diversification for the welfare of both their customers and equity holders. Secondly, financial institutions act as evaluators of credit risk for the depositor. Transaction cost theory has its origins in Ronald Coase’s (1937) classic article, The Nature of the Firm. According to Coase (1960) transaction costs include information acquisition costs and negotiation costs. Richter (1997) suggests that transaction costs include the monetary values of drawing contracts, signing contracts and the monetary value of monitoring and enforcing contracts.He follows that market prices govern the relationships between firms but within a firm decision are made on a basis of maximizing net income.Transaction costs incurred by financial intermediaries and financial institutions in financial exchange are related with credit risk in the form of collateral requirements, uncertainty, investments in specific issues and hefty costs incurred in monitoring grant credit facilities.

The findings bring out that the stage of credit was high in the early years of the implementation of Basle II, but decreased significantly in 2007 and 2008, probably when the Basle II was followed out by commercial banks. Notably, the level of nonperforming loans given by nonperforming loans to total loans decreased during the period 2004 to 2008. The demand by the Basle II might have enabled commercial banks to check their level of nonperforming loans thus reducing banks' credit risk.So, on the median profits of the banking industry increased during the period 2004 to 2008.However, profitability of the commercial banks fluctuated during the menses, but on average increased marginally during the period 2004 to 2008.The earnings were generally low during the period of work.The total of credit expanded to customers was relatively high, but assumed a downward movement during the menses.Whereas the level of credit and earnings were relatively low and stable, the quantity of credit was high and relatively volatile.The regression results show that there is no relationship between profits, the quantity of credit and the level of nonperforming loans.

The risk focused examination process has been taken over to direct the inspection process in the riskier areas of both operations and clientele. Skills in risk-focused supervision are continually being produced by exposing examiners to relevant training.By taking this approach, the banking industry, and specifically the small banks are sensitized to the demand to deliver formal and documented risk management frameworks (De Juan, 1991).Notably, the more complex a risk type is, the more specialized, centralized and controlled its management must be (Seppala, 2000).

Risk management is defined as the operation that a bank puts in place to manipulate its financial exposures.The process of risk management comprises the fundamental steps of hazard identification, hazard analysis and assessment, risk audit monitoring, and risk treatment or control (Baltimore, 2001).

Whereas a risk in simple conditions can be assessed using standard deviation, some risks may be difficult to measure requiring more complex methods of risk measurement. Sound risk management is not just a defensive mechanism, but also an offensive weapon for commercial banks and this is heavily hooked on the quality of leadership and organization.

Notes that a recognized risk is less "risky" than the unidentified risk. Risk is highly multifaceted, complex and often interlinked making it necessary to cope, rather than fear.While not avoidable, the risk is manageable - as a matter of fact, most banks live reasonably well by incurring risks, particularly "intelligent risks" (Payle, 1997).

Financial institutions are exposed to a diversity of risks between them; interest rate risk, foreign exchange risk, political risk, market risk, liquidity risk, operational risk and credit risk (Yusuf, 2003).

In some illustrations, commercial banks and other financial institutions have approved decisions that are not vetted, there has been instances of loan defaults and nonperforming loans, massive extension of recognition and directed lending.Policies to minimize on the negative effects have concentrated on mergers in banks and NBFIs, better banking practices, but stringent lending, review of laws to be in business with the global standards, well capitalized banks, which are anticipated to be profitable, liquid banks that are able to satisfy the needs of their depositors, and maintenance of required cash levels with the central bank which means less cash is available for lending (Mwega, M. (2009).
The research aims at examining the effect of credit risk management on financial performance of the Jordanian commercial banks, through identifying the index numbers of credit risk and financial performance ratios during the time period (2005- 2013), in that it investigates the overall and sub-total effect of the credit risk indicators of banks' financial performance using certain partial indicators of credit risk.The empirical findings suggest that there is a positive effect of the credit risk indicators of Non-performing loans/Gross loans ratio of financial performance, and a negative effect of Provision of Facilities loss/ Net facilities ratio of financial performance, and no effect of the Capital adequacy ratio and the credit interest/Credit facilities ratio on banks' financial performance when measured by ROA (Kane and Rice, 1998).

This is in agreement with Li and Zou (2014) who found that Non-performing loans/Gross loans has positive effects on the financial performance of firms, as measured by ROA and ROE, and with Abdelrahim (2013) and Li and Zou (2014) who concluded in their separated studies that the capital adequacy ratio has no effect on credit risk management, and with Boahene, Dasah and Agyei (2012) who found that some of credit risk indicators have a positive effect on banks' financial performance.

But this result is contrary to De Juan. (1991) who found that the rate of capital to total weighted risk assets has a positive effect while interest rate risk affects negatively the banks'financial performance, and Kurawa and Garba (2014) in their findings that credit risk management as measured by capital adequacy variable has a significant positive effect on the financial performance, and also is in consistence with results of Ogboi and Unuafe (2013) which revealed that effective credit risk management has a positive impact on bank's financial performance.

The researcher also found a positive effect of Non-performing loans/Gross loans ratio, and negative effect of Provision for facilities loss/Net facilities ratio on bank's financial performance, this conclusion is consistence with findings of Manzura and Juanjuan (2009), and is on contrary to the results of Brau, J. &Woller, G. (2004) who found that the Non-performing loan and other indicators have a positive effect on bank's financial performance.

Former analysis also revealed that an effect of the Credit interest/Credit facilities ratio and the leverage ratio on bank's financial performance as measured by ROE, where this result is contrary to the findings of Ogboi and Unuafe (2013), and in agreement with Kithinji (2010) who didn't find an effect of the amount of credit and nonperforming loans on bank's financial performance.

The overall effect of the credit risk management on financial performance is statistically significant as indicated by the computed F-statistic and its probability (0.0000) of the research models. Therefore, the research submits that there is an effect of credit risk management on bank's financial performance as measured by ROA and ROE. This result is consistence with the study of Abiola and Olausi (2014), and is in agreement Adebisi and Oladunjoye (2013) who found an effect of credit risk management on the profitability as measured by ROA and ROE.

3. Conceptual Framework

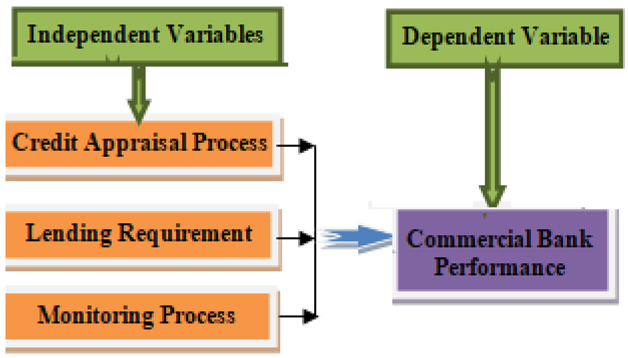

Figure 1.1: Frame Work(Mumbi Wanjugu Mercylynne, Job Omagwa, 2017)

4. Methodology

This survey was conducted through quantitative survey descriptive research design.

This pattern is considered suitable because is to determine whether and to what degree a relationship exists between quantifiable variables.So that questionnaire technique will be employed in compiling the primary information. Nevertheless, this work will be used quantitative approach; Quantitative is any data collection technique (such as a questionnaire) or data analysis procedure (such as graphs or statistics) that generates or uses numerical data (Saunders et al, 2009).

The target population of the study was some selected market in Mogadishu-Somalia, (Management and Employees), the researcher focuses on that person who permanently and temporarily working at the selected bank. The population stands at over 80 individuals. It is from this population that the sample size was derived.

This work will be applied qualitative methods for analyzing; the information will be used to represent and examine the information in an appropriate manner.The data will constitute use of Statistical Package for Social Science (SPSS) is a computer program used for survey authoring, information mining and statistical analysis.The researcher will utilize this plan because it is convenient and simple tool that is usable for the researcher more over SPSS V.20, as a tool for studying the data.

The method to analysis the data in this field will be quantities and quality approach. Quantitative deals with the numbers and charts. The frequency distribution method will use to dissect the data which establishes the dispersion of loads in a sample for a specific variable.This method yields a record number of times a score or response occurs; also its used to represent the information either with chart and boards.

Correlate
The effect of correlation analyzes the relationship between Credit Risk Management and Bank Performance.The Result indicates that Credit Risk Management has positive correlate on Bank Performance with beta value 0.815. That stands for the correlate between variables is 81.5% of beta value, this outcome is a high positive correlate among variables.

Table 4.3.1: Credit Risk Management and Bank Performance

Correlations			
		Credit Risk Management	Bank Performance
Credit Risk Management	Pearson Correlation	1	.815**
	Sig. (2-tailed)		0
	N	67	67
Bank Performance	Pearson Correlation	.815**	1
	Sig. (2-tailed)	0	
	N	67	67
**. Correlation is significant at the 0.01 level (2-tailed).			

5. Findings of the Study

Established on the findings in objective one presented that To determine the result of credit appraisal process on the financial operation of selected commercial bank in Mogadishu-Somalia scored Average mean 4.26 overall and this outcome indicates that the overall of objectives was Excellence.

Established on the findings in objective two presented that To examine the issue of lending requirements on the fiscal operation of selected commercial bank in Mogadishu-Somaliascored Average mean 4.43 overall and this outcome indicates that the overall of objectives was Excellence.

Established on the findings in objective three presented that To establish the effect of the monitoring process on the financial operation of selected commercial bank in Mogadishu-Somalia scored Average mean 4.43 overall and this outcome indicates that the overall of objectives was Excellence.

Established along the findings presented that Commercial Bank Performance (DV) scored Average mean 3.3 overall and this result indicate that the overall of objectives was good.

The effect of correlation analyzes the relationship between Credit Risk Management and Bank Performance.The Result indicates that Credit Risk Management has positive correlate on Bank Performance with beta value 0.815. That stands for the correlate between variables is 81.5% of beta value, this outcome is a high positive correlate among variables.

6. Conclusion

In this thesis researcher have been looking Credit Risk Management and Bank Performance. The research objective was three; first objective was to determine the effect of credit appraisal process on the financial performance of selected commercial bank in Mogadishu-Somalia. It can be concluded that the credit appraisal process has positive relations with financial performance.

The second objective was to examine the effect of lending requirements on the financial performance of selected commercial bank in Mogadishu-Somalia. It can be reasoned that the lending requirements have a positive impact on financial performance.

The third aim was to show the result of the monitoring process on the financial operation of selected commercial bank in Mogadishu-Somalia.It can be reasoned that the monitoring process has a positive impact on financial performance.

The effect of correlation analyzes the relationship between Credit Risk Management and Bank Performance.The Result indicates that Credit Risk Management has positive correlate on Bank Performance with beta value 0.815. That stands for the correlate between variables is 81.5% of beta value, this outcome is a high positive correlate among variables.

7. Recommendation

Established on the findings and conclusions on this subject, the following testimonial was prepared:

1) The study recommends that commercial banks should also try to maintain their operational cost low as this negates their profit margin thus leading to low financial performance.This is drawn by the substantial effect of net income on financial performance.
2) Commercial banks should also control their credit policy and practices.By this they would reduce losses on non-performing loans which gets up their expenses and consequent decrease in financial performance.

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