THE EFFECT OF RISK MANAGEMENT ON THE PERFORMANCE OF FINANACIAL INSTITUTIONS IN UGANDA

CASE STUDY: ECOBANK UGANDA (HEAD OFFICE KAMPALA)

BY

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DEDICATION

I dedicate this work to my parents Mr.WamukootaNandaah and Mrs.Wamukoota Juliet for all their financial and moral support, love and encouragement especially during the time have been carrying out this research. I would also like to dedicate this work to my brothers Denis, Pius, Jonathan, Joel and my sister Immaculate for encouraging words of wisdom as I undertook my research. Lastly, I dedicate this work to my close friends I have been with during my three years at the campus especially the late Mugabo Phillip (R.I.P).

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TABLEOF CONTENTS

DECLARATION i
APPROVAL ii
DEDICATION iii
ACKNOWLEDGEMENT iv
LIST OF TABLES vii
LIST OF FIGURES viii
ABSTRACT ix
ABBREVIATIONS xi
CHAPTER ONE 1
INTRODUCTION 1
1.0 General Introduction. 1
1.2 Background of the study 3
1.3 Statement of the problem 4
1.4 Objectives of the study 5
1.5 Research Questions 5
1.6Hypotheses 5
1.7 Scope of the study 6
1.8 Significance of the study 6
1.9 Justification of the study 7
1.10 Conceptual Frame work 8
1.11 Definition of key terms 9
1.12 Limitations to the study 10
1.13 Conclusion 11
CHAPTER TWO 12
LITERATURE REVIEW 12
2.1 Introduction 12
2.2 Overview of Risk management. 12
2.3 Types of risks faced by financial institutions 16
2.4 How banks mitigate these various risks 24
2.5 The Relationship between risk management and the performance of financial Institutions... 41
2.6 Conclusion 44
CHAPTER THREE 45
RESEARCH METHODOLOGY 45
3.1 Introduction 45
3.2 Research design 45
3.3 Area of the study 46
3.4 Study population 46
3.5 Sample size 46
3.6 Sampling procedures 47
3.7 Sampling techniques 47
3.8 Data Collection Methods and Instruments 48
3.9 Quality Control Methods 49
3.10 Data Management and Processing 51
3.11 Data analysis 51

3.12 Ethical consideration 52
3.13 Study Limitations 53
3.14 Conclusion. 54
CHAPTER FOUR 55
PRESENTATION, ANALYSIS AND INTEPRETATION OF FINDINGS 55
4.1 Introduction 55
4.2 Demographic Information of Respondents 55
4.4 How the bank manages the different risks 60
4.5 The Relationship between Risk Management and Performance of Ecobank 65
4.6 Conclusion 69
CHAPTER FIVE 70
SUMMARY, CONCLUSIONS AND RECOMMENDATIONS 70
5.0 Introduction 70
5.1 Summary of findings 70
5.2 Conclusions from the study 72
5.3 Recommendations from the study 72
5.4 Suggested areas for further research 74
REFERENECES 75
APPENDICES 81

LIST OF TABLES

Table 1: Showing the Distribution of Respondents by Sex 55

Table 2: Shows the description of respondents by Age (Eco bank) 56

Table 3: Working experience of respondents 57

Table 4: Showing the various Risks (Ecobank) 57

Table 5: Showing the management of various risks (Ecobank) 60

Table 6: Showing the Strategies used to mitigate risks 62

Table 7: Critical Success factors to proper risk management 63

Table 8: Challenges in managing risks (Eco bank) 64

Table 9: Descriptive Statistics for performance indicators 66

Table 10: Descriptive Statistics for Intervening factors that affect performance 68

LIST OF FIGURES

Figure 1: The three step risk management process 15
Figure 2: Line Graph showing the types of risks faced by financial institutions 58
Figure 3: Showing how the bank manage various risks (Ecobank) 61
Figure 4: Showing the challenges encountered by financial institutions (Eco bank) 64

ABSTRACT

The development of the banking industry globally and any business venture regardless of their temperament and management encounter various kinds of risks in their operations. Risks being one of an- predictable part of any business, require a well-developed strategy of risk management to take lead and many financial institution are still faced with the challenge of risk management in spite of having staff with skilled knowledge. However, Michel Crouhy et al (2007) clearly stated that institutions can comfortably earn their keep by taking lead in risk management. This research has therefore looked at the effect of risk management on the performance of banking institutions in Uganda with specific emphasis on ECOBANK UGANDA head office.

The study examined the existing literature on the topic under study and the empirical data required was obtained through questionnaires, review of recordsandinterviews with the staff and customers and other stakeholders respectively. The data was analyzed both qualitatively and quantitatively to ascertain the effect of risk management in financial institutions (Eco bank).

The key findings of the study show that the major risks encountered by financial institution are; credit risk, liquidity risk, foreign exchange risk, interest rate risk and operational risk. This is due to the fact that banks provide a myriad of services and involve themselves in many transactions hence being exposed to all these risks. The findings showed that the lack of a well-developed risk culture at Ecobank was the biggest challenge in managing risks.

The statistical analysis clearly showed that there is strong relationship between risk management and performance of financial institutions especially with regard to the return on equity, return on assets, profitability and net interest margin.

The study therefore, concludes and recommends that to ensure efficient and effective risk management in financial institutions; the management needs to improve of staff capacity development, communication channels, development of strong risk culture, formulation of risk management policies, constant review of the operations ,imparted into the stakeholders of the bank (customers and shareholders), installation of CCTV camerasin sensitivity areas. Therefore, a lot of efforts need to be put in by all staff of the organization to effectively enable the management of various risks encountered by the organization.

ABBREVIATIONS

FIA- Financial Institutions Act

BCBS- Basel Committee on Banking Supervision

IRM-Institute of Risk Management

CIMA-Chartered Institute of Management Accountants

ICAEW-Institute of Chartered Accountants in England and Wales

SBP- State Bank of Pakistan

NCISSE- National Colloquium for Information Systems Security Education

IFA- International Federation Of Accountants

CHAPTER ONE

INTRODUCTION

1.0 General Introduction.

Financial institutions worldwide have fundamental role they play in the financial system of different economies. According to Ceccheti(2006) financial institutions form up the fourth part of the financial system and they include banks, microfinance institutions, insurance companies hedge and mutual trust funds plus forex bureaus. These provide myriad of services depending on the industry in which the institution operates such as access to financial markets, keeping financial resources safe and readily available for use and provision of financial information among others. This research has however put more emphasis on banks with particular regard to the area of risk management .This attributed to a number of reasons such as technological progress, growth of international financial markets, diversity of financial instruments, new banking regulations such as Basel 3, the changing face of banking away from the traditional approach that has witnessed the creation of new products and services, the highly levered nature of banks which necessitates that they properly manage their risks or else they deplete their capital and the recent global financial crisis that saw major banks around the world collapse such as the Lehman brothers and Washington Mutual in the USA, and Northern Rock a mortgage firm in the UK among others. These reasons plus other factors have increased the need to have risk management to be embedded at the core of all banks activities.

Regionally, Enterprise risk management has become a hot button issue in virtually all sectors of the economy across East Africa. In particular within the financial services sector, risk management has grown in prominence largely as a result of regulatory push but also a means of protecting current assets while seeking competitive advantage .The emerging threats,

competition and rapid shift in business environment coupled with heightened regulatorydemands as well as new exciting opportunities such as regionalisation, improved technologies and enlightened customers with better spending power are the developments which have made organisations in the East African region to put in place policies and structures to manage risks presented by both opportunities and challenges in the market place. Nyang'aya (2012)

According to Bagyenda (2010) risk management in Uganda's local banks became prominent following the bank failures of the late 1990's she further argues that Bank of Uganda which supervises all financial institutions in Uganda has emphasized and issued strong risk management guidelines to supervised financial institutions which are line with internationally accepted risk management principles , best practices and also aligned with principle seven of the Basel core principles for effective banking supervision.

On the other hand ,section 10 of the Financial institutions act 2004 stresses that a company proposing to transact business as a financial institution shall clearly indicate in its written application its broad risk management policies and management operating procedures and systems that will ensure integrity of its financial controls .This exemplifies the central bank's commitment towards enhancing a sound financial system through emphasizing the need for efficient and effective risk management in the banking sector .

Therefore in reference to the above background and discussion, this research has been carried to establish the relationship between of risk management and performance of financial institutions with particular regard to Ecobank Uganda and the ideal risk management practises that financial institutions are required to undertake.

1.2 Background of the study

Ecobank whose official name is Ecobank transnational Inc. but also known as Ecobank transnational is a public limited liability company which was established as a bank holding company in 1985 under a private sector initiative spearheaded by the Federation of West African Chambers Commerce and Industry, with the support of the Economic Community of West African states (ECOWAS) having its first headquarters in Lome' Togo's capital. As of today, it has grown to become the leading pan –African banking conglomerate with extended banking operations in 35 African countries across the continent and four global business capitals, more than any other bank in the world and serving over 13.5million customers. In addition, the Ecobank Group is a full-service bank focused on Middle Africa providing wholesale, retail, investment and transactional banking services to governments, financial institutions, multinationals, local companies, SMEs and individuals with its services being delivered by three customer-focused business segments, Corporate Bank, Domestic Bank and Ecobank Capital all of which are supported by an Integrated IT platform operated by eProcess, the group's technology subsidiary. It also operates as "One Bank" with common branding, standards, policies, processes to provide a consistent and reliable service across its unique network.

In Uganda, Ecobank transnational Inc.opened up Ecobank Uganda and commenced operations in January 2009 with its headquarters in the capital Kampala and it has been able to expand its operations to set up thirteen networked branches so far in various parts of the country so as to reach out to the unbanked population through a variety of services as discussed above. As of December 2010, the bank's total assets were valued at about US$37.3 million (UGX: 91 billion).

1.3 Statement of the problem

Risk management has increasingly become a discipline at the core of every supervised financial institution and it encompasses all activities that affect an institutions risk profile. Excessive or poorly managed risk can endanger the safety and soundness of a financial institution and overall financial system Bagyenda (2010) .There are series of benefits that accrue to institutions that employ effective and efficient risk management risk management policies in their business such as increased profitability and better business reputation.

However, many financial institutions have well educated staff but risk management has been left to mainly top management, yet the majority of the risks that financial institutions face are encountered at the lowest level of management which need close supervision. The lower level employees in an organisation take no keen interest on what was not indicated in their job description and hence not minding the risk of their daily transactions. Financial institutions therefore end up in riskytransactions which eventually lead to the decline in performance as well as failure to achieve organisational objectives and goals in the long run. However, even up to now some organisations have not fully appreciated the value of risk management. The major area of concern in this research is how various stake holders in banks are well versed with the area of risk management .This has therefore necessitated this study to be undertaken so as to establish the impact of risk management on the performance of financial institutions particularly banks and how knowledgeable they are plus well suited to face the risks that come their way.

1.4 Objectives of the study

1.4.1. General objectives

- The main objective of the study is to establish the effect of risk management on the performance of financial institutions. (Ecobank Uganda)

1.4.2 The Specific Objectives

- To find out the different kinds of risks faced by financial institutions.
- To investigate the various risk management processes and how financial institutions mitigate these risks.
- To establish whether there's a relationship between risk management and performance of financial institutions.

1.5 Research Questions

1. What are the different kinds of risks faced by financial institutions?
2. What are the main reasons why financial institutions are involved in risk management?
3. What are the various ways financial institutions use to manage risks and create value?
4. Do you think there's a relationship between risk management and performance of financial institutions?
5. What are the challenges faced by financial institutions in in managing risk and performance?

1.6 Hypotheses

The following hypotheses were used to test effect of risk management on the performance of financial institutions.

- ✓ Risk management has no effect on performance of financial institutions.
- ✓ Risk management has a positive effect on performance of financial institutions

1.7 Scope of the study

The study is based entirely at Ecobank Kampala as a case. It was limited to establishing the effect of risk management and performance of financial institutions. It also sought to find out various types of risks faced by this bank and how the minimize these risks. This research was carried out based on the objectives covering credit risk, interest rate, liquidity risk, operational risk and foreign exchange risk which are the main areas of risk management in banks and has looked at information covering the period between 2009-2013

1.8 Significance of the study

Risk management has increasingly become an essential element necessary for the successful operation of any financial institution, it's necessary to cultivate a strong risk culture within each organisation so as to combat the different challenges associated risk management. It is therefore hoped that the following parties may benefit from the findings and recommendations of this study:

a) The board of directors of the financial institution, to make sure they are at the forefront of risk management within the organisation by determining how they want the organisation to be run as well as which management team to appoint in the institution.

b) The information from this study could also help the managers of this institution to identify areas which require more reinforcement and are necessary for improving the performance of the institution with particular concern to risk management.

c) The research will also provide detailed understanding on relationship between risk management and the performance of financial institutions to the researcher as well as provide information relevant to facilitate future research publications.

d) The public and shareholders will also benefit from the research due to the fact that they are the customers of these institutions and will certainly want to know how organizations such as banks handle the resources entrusted to them.

e) To the researcher, the study will provide detailed information on financial reporting and decision making which will broaden the knowledge and ability in research work which could be applied elsewhere.

1.9 Justification of the study

It is becoming a common trend in these days that many of the upcoming businesses are falling apart, do not succeed and do not live to the dreams of the owners. To worsen the matters, even for those who have been in the business for some good times ask the question as to why they do not maintain customers and fail to manage the risks associated with their businesses? Yet to the imagination of the business owners, is to realize big margin profits in the future, but to their surprise the total costs are greater than total revenue which could be due to various risks. The logical reason is that the daily loss of finances which is associated various risks have affected the performance of some financial institutions in Uganda. Some of these business finance service firms have failed to revise their banking systems and policies and have failed to realize expected profits. Ecobank is in the risk business just like any other commercial bank in Uganda. Ecobank in its process of providing financial services, they assume various kinds of financial risks. Over the last decade the understanding of the place of commercial banks within the financial sector has improved greatly and but still need a lot of effort in the area of risk management.

Therefore this justifies the importance of this research especially in the field of risk management in financial institutions.

1.10 Conceptual Frame work

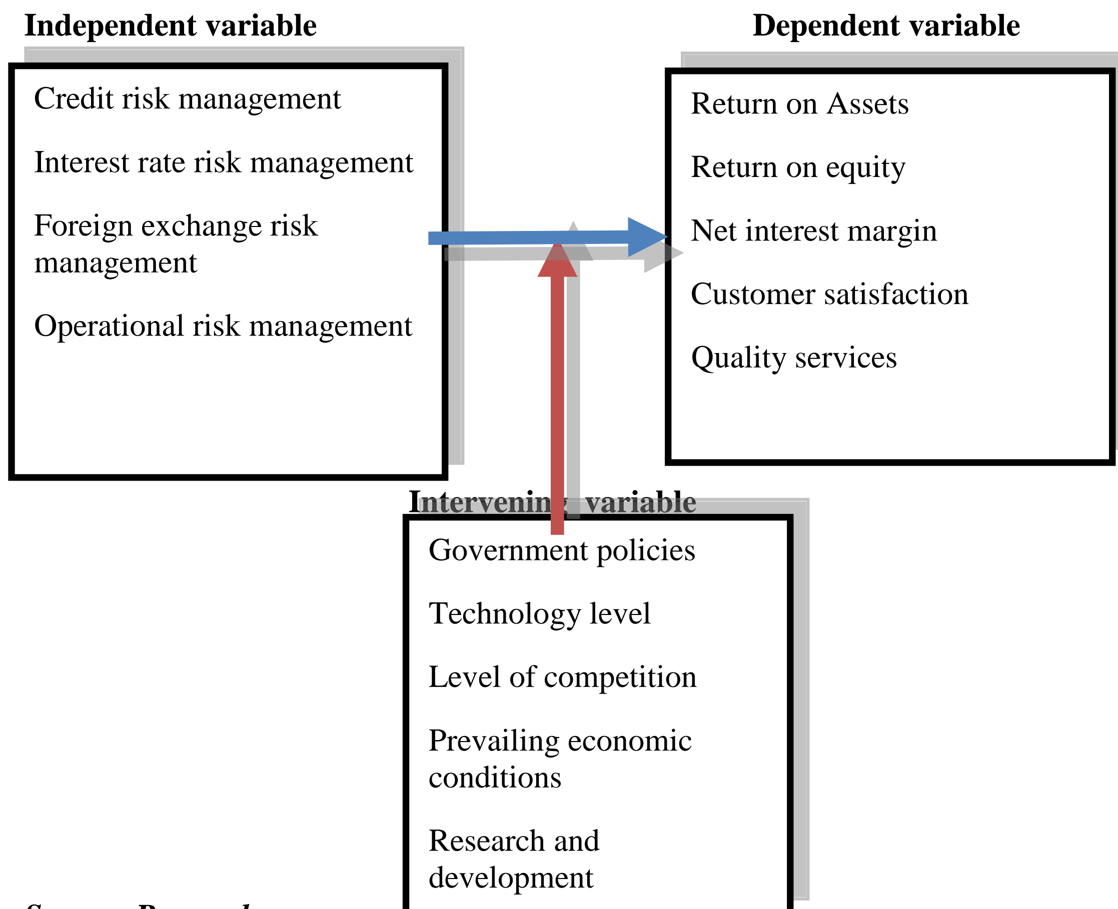
The conceptual frame work elaborates on how risk management influences the performance of financial institutions. Risk management involves risk identification, assessment and measurement, control and maintaining as well as putting in place measures to reduce on the effect of the risks in case they are unavoidable.

Depending on the level of risk management, the organisation will be able to satisfy its customers through the provision of quality services, its profit making levels will be affected as well as its expansion level. Effective risk management indicates that the bank operates their activities at lower relative risk and lower conflict of interest between parties. The advantages of implementing better risk management leading to better bank performance. Better bank performance increases its reputation and builds customer confidence in their services and increases asset quality earnings, liquidity and profitability. (Cebenoyan and Strahan 2004).

It should be noted that risk management alone does not influence the performance of financial institutions. There are also other additional factors like the research and development undertaken in the organisation, the government policies, prevailing economic conditions, level of competition, technology levels and the political climate in the country in which the organisation is situated will all influence the performance of the organisation.

This illustration below indicates how risk management and intervening variables influence the performance of financial institutions.

Figure 1: Conceptual Framework



Source: Researcher

1.11 Definition of key terms

Risk

According to Bagyenda (2011), risk refers to the possibility that the outcome of an action or event could bring adverse impact on the institutions capital, earnings and or viability.

However, Rose (2010) looks at risk in the perspective of a manger or to a regulator supervising financial institution means perceived uncertainty associated with a particular event

Risk management

Feridun (2006) defines risk management as the process of measuring or assessing the risks and the developing strategies to manage the risks such as transferring the risk to another party, avoiding the risk, reducing the negative effect of the risk and accepting some or all of the consequences of a particular risk.

Financial institution;

The Financial Institutions Act (2004) of Uganda defines a financial institution as a company licensed to carry on or conduct financial institutions business in Uganda and it can be a commercial bank merchant bank, post office savings bank, credit institution, a building society, an acceptance house, a finance house or any institution which by regulations is classified as a financial institution by the central bank.

1.12 Limitations to the study

1. The major limitation to the study was the unwillingness of some employees to pass on information regarding risk management and performance and some employees also failed to fill in the questionnaires 'due to fear of committing themselves.
2. Lastly the research had another problem which was due to the extremely busy nature of most of the employees especially department heads and this is proved to be costly both in terms of time and money to the researcher as most appointments had to be rescheduled.

1.13 Conclusion

Risk management is of great significance in the performance of financial institution in Uganda as illustrated in the conceptual framework. This chapter has covered the origin of risk management over the years in commercial banks and this enabled the researcher to understand the gap between risk management in Uganda's financial institutions especially commercial banks whose details can be cited in the following chapters.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter examines the relevant literature related to the main variable of Risk management and performance of financial institutions from various authors and scholars. A profound understanding of these hypothesis and procedures will clearly and precisely bring out the importance of risk management on performance of financial institutions. It looks at the various types of risks and how to minimize these risks. It also includes the discussion of the relationship between risk management and performance of financial institutions.

2.2 Overview of Risk management.

2.2.1 Risk

According to Raghavan (2003), risk is inherent in any walk of life in general and in financial sectors in particular making risks and uncertainties form an integral part of banking which by nature entails taking risks**.** Business grows mainly by taking risk. Greater the risk, higher the profit and hence the business unit must strike a trade-off between the two. The essential functions of risk management are to identify measure and more importantly monitor the profile of the bank.

Every human activity involves some kind of risk, for example crossing the road, engaging in sporting activities, taking the bus, starting a new business et cetera. These are normal daily life activities and yet involve some kind of risks. We can however try to minimize such risks by following recommended guidelines or try to avoid partaking in such activities that are considered risky. What is risk then? Even though there is no single generally accepted definition for risk it is a common word used in connection with insurance, finance, banking

and can be defined in many ways depending on the person defining it (Dorfman, 2007). In the insurance industry, the term risk refers to the exposure to loss. According to Mun (2004), “risk is any uncertainty that affects a system in an unknown fashion whereby the ramifications are also unknown but bears with it great fluctuation in value and outcome”.

Risk can be defined as the combination of the probability of an event and its consequences (IRM et al., 2002). According to ICAEW (1999), risk is defined as real or potential events which can reduce the likelihood of achieving business objectives. Risk has also been defined as: “uncertain future events which could influence the achievement of the organization’s strategic, operational and financial objectives” (IFA, 1999). Risk is all about events and their consequences which can happen in the future. As at now, we do not know what event will occur in the next hour, tomorrow or next year and if it does occur what its consequences will be. In other words, how likely it is that an event will happen and how bad it will be if it happens. This therefore implies that there is uncertainty about events and their consequences see **figure 2**.

2.2.2 RISK MANAGEMENT

Recent years have seen heightened concern and focus on risk management, as a result of series of business scandals and failures where investors, company personnel and other Stakeholders suffered tremendous loss. This resulted in the publication of books, journals, articles and a series of government documents that draw attention to the need for better risk management and how to set up a risk management system. However, over the last few decades, risk management has become an area of development in financial institutions. The area of financial services has been a business sector related to conditions of uncertainty. The financial sector is the most volatile in the current financial crisis. Activities within the financial sector are exposed to a large number of risks. For this reason, risk management is

more important in the financial sector than in any other sectors (Carey, 2001). Carey regards financial institutions as the main point of risk-taking in an uncertain environment.

Risk management is viewed as a corner stone of good corporate governance and therefore results in better service delivery, more efficient and effective use of scarce resources and better project management (Collier et al., 2007). It has to do with identification, analysis and control of such risks that threaten resources, assets, personnel and the earning capacity of a company.

Risk management is: "a process of understanding and managing the risks that the entity is inevitably subject to in attempting to achieve its corporate objectives. For management purposes, risks are usually divided into categories such as operational, financial, legal compliance, information and personnel. One example of an integrated solution to risk management is enterprise risk management" (CIMA, 2005). The Institute of Risk Management also provided a more detailed definition of risk management as: the processes by which organizations methodologically address the risks to their activities with the goal of achieving sustained benefit within each activity and across the portfolio of all activities (IRM et al., 2002).

Risk management involves identifying, measuring, monitoring and controlling risks. The process is to ensure that the individual clearly understands risk management and fulfills the business strategy and objectives (SBP, 2003). Based on the definition above, the meaning of risk involves:

• The likelihood and consequence of something occurring.

• The chance of something happening impacting the achievement of objectives.

And risk management is about:

• The process to eliminate, reduce and control risks.

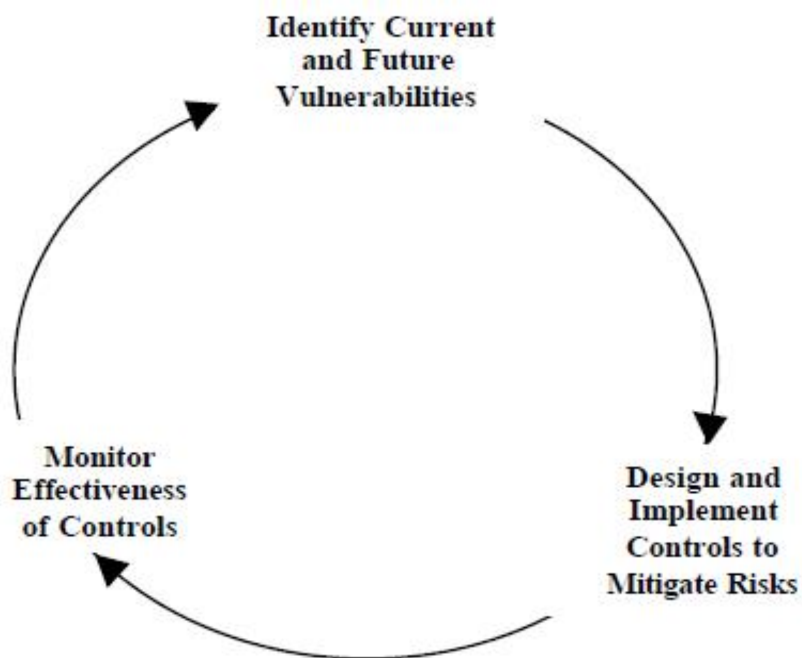
• It involves identifying, analyzing, measuring, monitoring and controlling risks

• Reducing the negative and emerging opportunities.

• Achievement of business strategy and objectives.

Risk management, or the process of taking calculated risks, reduces the likelihood that a loss will occur and minimizes the scale of the loss should it occur. *Risk management* includes both the prevention of potential problems and the early detection of actual problems when they occur. As such, risk management is an ongoing three-step process

Figure 2: The three step risk management process



Source: Adapted from NCISSE 1998

The principle of risk management is at the heart of information security. It forms part of such standards and frameworks as security management should follow a risk management cycle such as the one below

1. Identify the current and the future vulnerability: Identify the needs based on an assessment of information security risks based on:
    - Risk Attitude and Awareness – *"Appetite"*
    - Evaluation of *impact* and *likelihood*
2. Define and design desired results in terms of
    - Scope of protection
    - Tolerance
    - Effort – Budget & manpower
    - Response
    - Allowable residual risk
3. Determine appropriate Strategies and build business case
4. Implement selected strategy or strategies via policies and controls
5. Monitor the effectiveness of policies and controls and Report and review reports and evaluate the strategy which can be adjusted as part of the continuous improvement of the cycle. Therefore for risk management to be more effective there is a need for the manager of these financial institutions to follow up these three major steps.

2.3 Types of risks faced by financial institutions

2.3.1 Credit risk

Hennie and Sonja (2003) defined it as the chance that a debtor or financial instrument insurer will not be able to pay interest or repay the principal according to the terms specified in the credit agreement. They contend that in such a scenario, payment may be delayed or no payment is done at all which can in turn cause cash flow problems as well as affect banks liquidity and is still the major cause of banking failure because more than 80 percent of a bank's balance sheet generally relates to this aspect of risk management. They conclude their argument by emphasizing the need to perform a comprehensive evaluation of a bank's

capacity to assess, administer, supervise, enforce and recover loans, advances, guarantees, and other credit instruments because of the potentially dire effects of credit risk

Rose (2010) on the other hand defines this risk as the probability that some of the probability that some of the financial institutions assets, especially its loans will decline in value and perhaps become more worthless. This is because firms hold little of owner's capital relative to the aggregate value of their assets.

These arguments in my view both suggest that credit risk affects the rate of return on a bank's assets particularly loans as these form up the biggest percentage of most banks assets.

In addition, Raghavan (2003) argues that credit risk consists of primarily two components which are quantity of risk, which is nothing but the outstanding loan balance as on the date of default and the quality of risk described as the severity of loss defined by both probability of default as reduced by the recoveries that could be made in the event of default.

The Basel committee on banking supervision in its principles for the management of credit risk issued in 2000 asserts and clearly stipulates that most common sources related to credit risk arise from the broad areas of concentrations, credit processing, and market- and liquidity-sensitive credit exposures.

According to Kendall (1998)

- Credit risk is defined by Kendall (1998: 119) as "the likelihood that a transaction or transactions with counterparty will be defaulted upon through that counterparty's inability to meet its financial needs". Essentially, it is the risks that counterparty to a deal fails to perform as arranged. Goodspeed(205: 47) breaks down credit risk into five elements:

- **Settlement risk:**

The risk that settlement/completion of a transaction does not take place as expected.

- **Country risk:**

The risk of political/economic events in a foreign country leading to a situation where interests in those countries are adversely affected. An example could be foreign governments reneging on interest payments of an international government bond.

- **Collateral risk:**

This is the risk of potential financial loss due to inability to recover the full collateral value because of unforeseen events (such as legal impediments or adverse market movements).

- **Concentration risk:**

This is the risk of loss due to the concentration of exposure. This could mean overexposure to geographical, industrial or demographic groups (e.g. gender or income). Overexposure to a single group is considered risky because if that group's preferences change, your company may lose a significant amount of business. This is essentially a risk caused by a lack of diversification

- **Industry risk:**

Counterparties to a transaction may default because of industry-specific factors. In other words, various industries may be subjected to common events. In the commercial world, a practical example would be the economic slowdown for the general retailing sector when interest rates increase

2.3.2 Liquidity risk

Santomero and Babbel (2001) describe it as the risk to the institution that there will be a sudden call upon its resources that will strain its financial capacity. The strain is exacerbated when the financial assets themselves are insufficiently liquid to cash in without accepting a sizeable reduction in their sales price. Liquidity risk is most often thought of as a sudden liability short fall that is associated with a deposit withdrawal for depository institutions, or with decline in borrowing capacity for institutions like finance companies. It may also be experienced by insurance firms, pension funds, or mutual funds as a sudden out flow to their customers. Sometimes, this risk is increased when perceived liquidity problems lead to a run on the financial institution. They however conclude their argument by stating that too much liquidity can also be a liquidity risk especially liquidity arises at a time when investment opportunities are unattractive

According to a paper issued by the Basel committee on banking supervision in 2008, liquidity is the ability of a bank to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses. The committee further stated that the fundamental role of banks in the maturity transformation of short-term deposits into long-term loans makes banks inherently vulnerable to liquidity risk, both of an institution-specific nature and that which affects markets as a whole. This can attributed to the fact that banks being deposit taking institution take in deposits that are often repayable on demand or at short notice and use these deposits to fund credit facilities to borrowers over longer periods and because virtually every financial transaction or commitment has implications for a bank's liquidity. Ceccheti (2010) argues that all financial institutions face the risk that their liability holders will seek to cash in their claims for example a holder of a checking account can always walk into the bank and ask for the balance it can therefore be defined as a sudden demand for cash by a bank's customers. He however asserts that banks face liquidity risk on both sides of their

balance sheet with deposit withdrawals being liability side risk and asset side risks such as failure to honor loan commitments.

This argument relates to that of Raghavan (2003) who also in his view asserts that liquidity risk is faced by banks on both sides of their balance sheet by stipulating that liquidity consists of funding risk which is the need to replace net out flows due to unanticipated withdrawal or non- renewal of deposit, time risk described as the need to compensate for non- receipt of expected inflows of funds especially performing assets turning into non- performing assets and call risk happens on account of crystallization of contingent liabilities and inability to undertake profitable business opportunities when desired.

He concludes his argument by putting emphasis on the need for asset liability management (ALM) is a part of the overall risk management system in the banks which basically implies examination of all the assets and liabilities simultaneously on a continuous basis with a view to ensuring a proper balance between funds mobilization and their deployment with respect to their maturity profiles, cost, yield, risk exposure among others. This assertion resonates with Hennie and Sonja (2003) who contend that liquidity risks are normally managed by a bank's Asset Liability Committee (ALCO) who must have thorough understanding of the interrelationship between liquidity and other market and credit risk exposures on the balance sheet.

From the above arguments a deduction can be that a financial institution will experience liquidity risk if it fails to meet its financial obligations at a reasonable cost and within an acceptable time frame thereby negatively on its earnings or capital and eventual failure of a financial institution

2.3.4 Interest rate risk

Santomero and Babbel (2001) argue that in the context of a financial institution, it is the risk is that the value of the liability portfolio will rise more rapidly if interest rates decline, or fall more slowly if interest rates increase, than will the market value of the asset portfolio. They further go on to state that such relative movements in the asset portfolio values could shrink the financial institutions economic equity.

In relation to the above, Rose (2010) argues that when interest rates change in the financial market place, the sources of revenue that financial institutions receive especially interest income on loans and investment securities and their most important source of expenses specifically interest cost on borrowings must also change. These changing interest rates also change the market value of assets and liabilities thereby changing a financial institutions net worth.

It is important to note that in Uganda interest rates are partly influenced by the monetary policy set by the Bank of Uganda

The Basel committee on banking supervision states that interest rate risk is the exposure of a bank's financial condition to adverse movements in interest rates and accepting this risk is a normal part of banking and can be an important source of profitability and shareholder value. However, excessive interest rate risk can pose a significant threat to a bank's earnings and capital base.

It further goes on identify the sources of interest rate risk as being re-pricing risk which arises from timing differences in the maturity (for fixed-rate) and re-pricing (for floating-rate) of bank assets, liabilities, and OBS positions, yield curve risk that arises when unanticipated shifts of the yield curve have adverse effects on a bank's income or underlying economic value and basis risk which arises from imperfect correlation in the adjustment of the rates

earned and paid on different instruments with otherwise similar re-pricing characteristics. When interest rates change, these differences can give rise to unexpected changes in the cash flows and earnings spread between assets, liabilities and OBS instruments of similar maturities or re-pricing frequencies.

In a related argument, the trading and activities manual (1998) states that accepting this risk is a normal part of banking and can be an important source of portability and shareholder value. However, excessive levels of interest rate risk can pose a significant threat to an institution's earnings and capital. It also goes ahead to stipulate the primary sources of interest rate risk being differences in the timing of the re-pricing of bank assets, liabilities, and off-balance-sheet (OBS) instruments, basis risk and the options in many bank asset, liability, and off-balance-sheet portfolios.

Changes in interest rates largely affect a financial institution's earnings and capital by changing its net interest income, the market value of the trading account and other interest sensitive incomes and expenses such as mortgage fees. It's also important to note that among the indicators of high inherent interest rate risk include significant reliance on income from treasury bills, significant reliance on time and a significant long term cumulative gap between interest sensitive assets and interest sensitive liabilities

2.3.4 Foreign exchange risk

Foreign exchange risk is the risk that a bank may suffer loss as a result of adverse exchange rate movement during a period in which it has an open position, either spot or forward or both in same foreign currency. Raghavan (2003)

Santomero and Babbel (2001) on the other hand argue that this risk is analogous to interest rate risk in that it measures the change in equity value due to variation in the level of exchange rate. They further state that as institutions invest and borrow globally, the currency

of transactions need not be the same as that of the institutions home market and therefore when a firm's assets and liabilities are denominated in different currencies, the institutions value will change with currency fluctuations. Banks that maintain correspondent relationships with foreign banks or that support customer transactions denominated in foreign exchange are exposed to much higher levels of currency risk and is still higher for banks that lend and borrow in foreign exchange as this may result in open currency positions or maturity mismatches (Hennie and Sonja, 2003)

2.3.5 Operational Risk

This refers to uncertainty regarding financial firm's earnings due to failures in computer systems, errors and misconduct of employees for example by engaging in fraudulent behaviour. Hennie and Sonja (2003) argue that these risks may include fraud risk, transaction risk and technological risk which can result into losses since they arise from the internal process of the organisation. Operational risk is inherent in all banking products, activities, processes and systems, and the effective management of operational risk has always been a fundamental element of a bank's risk management programme. As a result, sound operational risk management is a reflection of the effectiveness of the board and senior management in administering its portfolio of products, activities, processes, and systems BCBS(2011).The committee further goes on to stipulate the lines of defence upon which operational risk is based

On the other hand KPMG (2013) defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.

According to Porter (2008) the major sources of these risks include people, processes, systems and external events

2.4 How banks mitigate these various risks

2.4.1Credit risk Management

The Basel committee on banking and supervision stresses that the goal of credit risk management is to maximise a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters. The committee further emphasizes the need for banks to manage the credit risk inherent in the entire portfolio as well as the risk in individual credits or transactions as well as consider the relationships between credit risk and other risks. This is because effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organisation.

On the other hand, Santomero and Babbel (2001) contend that credit risk management is important because just like the way banks worry about the deterioration in the credit worthiness of their borrowers whose borrowings are listed as assets (loans) on the balance sheet of these institutions, investors in the liabilities of financial institutions specifically the savers, depositors, policy owners , pensioner lenders, deposit insurers are also concerned about the credit quality of financial institutions assets because ultimately the performance of the assets determines the financial institutions ability to meet the obligations of their liabilities. They therefore suggest a number of ways banks and other financial institutions can manage this risk among which include;

Purchase of a number of credit derivatives which are bilateral financial contracts between a protection purchaser and a protection seller that compensate the purchaser based on the occurrence of a credit event over the course of a future time period pre-specified in the contract. The authors further develop this point of view by saying that the credit event must be objective and observable such as a default, bankruptcy filing, rating downgrade or a

sizable drop in market price. These derivatives include credit swaps, index swaps , first to default swaps.

Taking a highly disciplined approach to investing which involves diversifying across broad sectors as well as across rating or issuing firms .In this way if it chooses judiciously, the institution, the institution takes investment positions in assets whose values tend to increase when there’s credit risk .Thus at a particular time when losses are occurring in the loan portfolio due to bad credit experience, profits are being made on the hedge portfolio that offset the losses.

Having strong reserves and sufficient equity capital to with stand any adverse any adverse experience in credit risk.

Strictly limiting the exposure to credit risk by investing only small amounts in risky credits while investing the remainder in high grade credits.

Where a financial institution fails to maintain the minimum amount of liquid assets it shall not grant any new or additional loan or credit accommodation to any person without the prior written approval of the Central Bank

Monitoring of the credit quality of loans and investments it has made so that it can attempt to make a hasty exit or take loss mitigation measures when problems arise. The authors suggest that through careful loan underwriting and for large commercial loans, the risk assessment process is similar to that which would be used by any credit rating specialist. Whereas for retail and individual loans commercial banks rely on the 5.C’s of credit which are designed to assess the ability and willingness of the borrower to repay the debt namely;

- Character which entails assessing the character of the borrower aided by things like credit reports ,job stability and credit references

- Capacity which is a ratio analysis of the cash flow of a borrower so as to establish a customer's ability to repay the loan
- Capital which is the investigation of the borrowers wealth
- Conditions where analysis of the economic scenarios or conditions that could give rise to default in an attempt to estimate the probability of default.
- Collateral and this basically a provision for recover in case of default by a customer.

Mutebile (2010) in a related argument states that, banks should enhance risk profiling of their customers. They should go beyond the traditional 'Know Your Customer' (KYC) to Enhanced Customer Due Diligence (ECDD). This can also serve to reduce the credit risk faced by banks.

The Basel committee on banking supervision in its principles for the management of credit risk issued in 2000 clearly identifies the major areas of concern for a commercial banks credit risk management programs which include establishing an appropriate credit risk environment, operating under a sound credit- granting process, maintaining an appropriate credit administration, measurement and monitoring process and ensuring adequate controls over credit risk. The committee however argues that although specific credit risk management practices may differ among banks depending upon the nature and complexity of their credit activities, a comprehensive credit risk management program will address these four areas. It's however important to note that these practices should also be applied in conjunction with sound practices related to the assessment of asset quality, the adequacy of provisions and reserves.

In establishing an appropriate credit risk environment, the committee emphasizes in its principles the role of the board of directors, senior management and the need to manage credit risk inherent in all products and activities.

According to Principle one by the BCBS (2000), the board of directors should have responsibility for approving and periodically (at least annually) reviewing the credit risk strategy and significant credit risk policies of the bank. The strategy should reflect the bank's tolerance for risk and the level of profitability the bank expects to achieve for incurring various credit risks. The committee further goes ahead to some components of the credit strategy developed usually developed by the board of directors among which include willingness to grant credit, overall characteristics the bank would want to achieve in its credit portfolio, recognition of the goals of credit quality and periodic review of the financial results to determine the changes to be made among others

In a related case, here in Uganda, section 7 (1)of the financial institutions (Corporate Governance) Regulations, 2005 states that the Board shall establish specialised committees of directors for better utilisation of its scarce resources and attaining more in-depth review of issues or areas pertaining to the operations of the financial institution such as the risk management committee. Section 10 further states that the risk management committee shall provide oversight of the senior management's activities in managing credit, market, liquidity, operational, legal and other risks of the institution.   These regulations also emphasize the role of board of directors in establishing an appropriate credit risk environment.

Another way banks can manage credit risk still in relation to establishing an appropriate credit risk environment is through proper implementation of the formulated credit strategy or policy. This is well elaborated in principle 2 issued by the committee which states that senior management should have responsibility for implementing the credit risk strategy approved by the board of directors and for developing policies and procedures for identifying, measuring, monitoring and controlling credit risk. Such policies and procedures should address credit risk in all of the bank's activities and at both the individual credit and portfolio levels. The committee further goes on to say that the cornerstone for safe and sound banking is the design

and implementation of written policies and procedures related to identification, measuring and monitoring of credit risk. These policies should however address such topics as target markets, portfolio mix, structure of limits, internal and .external factors relating to market positions plus trade area.

In relation to the above, the policies should be clearly defined and consistent with prudent banking practices, relevant regulatory requirements and adequate for the nature and complexity of banks activities .However one important aspect the committee highlights is the essence of effective communication of the policies throughout the organisation throughout the organisation this is because policies and procedure that are properly developed, implemented and communicated will enable the bank to maintain sound credit granting standards, monitor and control credit risk, properly evaluate new business opportunities and identify and administer problem credit.

In establishing an appropriate credit environment so as to mitigate credit, banks need to consider the types of financial products they advance to customers particularly regarding extension of credit. According to principle 3 issued by the Basel Committee on Banking Supervision on management of credit risk, Banks should identify and manage credit risk inherent in all products and activities. Banks should ensure that the risks of products and activities new to them are subject to adequate risk management procedures and controls before being introduced or undertaken, and approved in advance by the board of directors or its appropriate committee. The build up towards the financial crisis that witnessed the collapse of big banks around the world such as Lehman brothers, Deutsche bank and Washington mutual can be attribute to the failure of these banks to identify and manage the credit risk inherent in the products they were dealing in for example the subprime crisis in the United States is attributed to issuing of subprime or self-certified loans by banks which were too risky. It should be noted the greed exhibited by most banks saw them engage in activities

that were beyond their area of expertise for example investment banks got into home loans and mortgages without the right controls.

Another way banks can manage credit risk according to the Basel Committee on Banking Supervision is through operating a sound credit granting process. Principle 4 states that Banks must operate within sound, well-defined credit-granting criteria. These criteria should include a clear indication of the bank's target market and a thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit, and its source of repayment. A sound credit granting process should among other things consider or set out who's legible for credit, what types of credit are available and under what terms and conditions should the credit be granted and therefore sufficient information is necessary to enable a comprehensive assessment of the true risk profile of the borrower or counter party.

Banks need to understand to whom they are granting credit to and therefore banks must become familiar with the borrower and be confident that they are dealing with an individual or organisation of sound repute and credit worthiness. Therefore policies should be put in place to avoid association with individuals involved in fraudulent activities or other crimes for example by asking for references, assessing credit registries and becoming familiar with individuals

Banks should also have procedures where in consideration of credit it is appropriate to classify a group of obligors as connected counterparties and, thus, as a single obligor. This would include aggregating exposures to groups of accounts exhibiting financial interdependence, including corporate or non-corporate, where they are under common ownership or control or with strong connecting links (for example, common management, familial ties). Banks should also have procedures for aggregating exposures to individual clients across business activities.

The committee also asserts that collateral cannot be a compensate for insufficient information and banks need to be mindful that the value of the collateral may well be impaired the by the same factors that have diminished recoverability of the credit. In addition to this, banks should also have polices covering the acceptability of various forms of collateral procedures for the on-going valuation of such collateral and a process to ensure that collateral is and continues to be realisable.

With regard to guarantees, banks should evaluate the level of coverage being provided in relation to the credit quality and legal capacity of the guarantor. Banks should therefore be careful when making assumptions about implied support from third parties such as the government.

Credit risks especially in interbank transactions can be managed through netting agreements however in order to reduce risk such agreements need to be sound and legally enforceable.

According to principle five of the BCBS (2000), banks should establish overall credit limits at the level of individual borrowers and counterparties, and groups of connected counterparties that aggregate in comparable and meaningful manner different types of exposures, both in the banking and trading book and on and off the balance sheet. Exposure limits are needed in all areas of banking activities that involve credit risk which help ensure that the banks credit granting activities are adequately diversified.

In relation to the above, section 6(1) of the financial institutions(limits on credit concentration and large exposures) Regulations,2005 of Uganda states that a financial institution shall not grant or promise to grant to a single person or to persons with common interest an advance or credit accommodation which is more than 25% of its total capital .This is supported by section 11(1) which states that every financial institution shall have sound administrative and accounting procedures and internal control mechanisms for the purpose of

identifying, recording and monitoring all large exposures and subsequent changes to them, in order to ensure compliance at consolidated level (head or main office)and branches with the limits on credit concentration. It should be noted that if such regulations are followed, credit risk can be managed.

Hennie and Sonja (2003) in their argument about large exposures assert that banks should be prevented from relying excessively on a large borrower or a group of borrowers as this can pose a serious risk but they still hold a position that banks should not be dictated upon especially regarding who to lend

Internal confidentiality arrangements such as ‘Chinese walls’ should be established to ensure that there’s no hindrance to the bank obtaining all relevant information from the borrower. This occurs especially in situations where actual or potential conflict of interest exists within the bank. Santomero and Babbel (2001) state that these Chinese walls are mainly used by investment banks to lessen suspicion about self-dealing between the securities underwriting, the sales operation and the investment management business.

Principle six on the management of credit risk according to the BCBS(2000) states that banks should have a clearly-established process in place for approving new credits as well as the amendment, renewal and re-financing of existing credits. The committee further argues that since this whole process involves the work of individuals in different functions such as business origination, the credit analysis and the credit approval function coordinating the efforts of all of the various individuals in order to ensure that sound credit decisions are made.

In relation to the above, the committee also suggests banks should make sure that all approvals should be made in accordance with the bank’s written guidelines and granted by the appropriate level of management. There should be a clear audit trail documenting that the

approval process was complied with and identifying the individual(s) and/or committee(s) providing input as well as making the credit decision. This can be achieved through the establishment of specialist credit groups to analyse and approve credits related to significant product lines, types of credit facilities and industrial and geographic sectors though investment in adequate credit decision resources is necessary to enable making sound credit decisions consistent with their credit strategy and meet competitive time, pricing and structuring pressures.

From these arguments, it can be summed up that credit risk continues to be a primary area that gets financial institutions into trouble and if not properly managed, credit risk can lead to the collapse of a financial institution as it's intertwined with all other aspects such as liquidity, earnings and capital. It should also be noted that one of the major reasons for the closure of financial institutions in 1998/1999 was attributed to weaknesses in credit risk management

2.4.2 Interest rate risk management

Rose (2010) argues that when interest rates change in the financial market place, the sources of revenue financial institutions receive especially interest income on loans and investment securities and their most important source of expense specifically interest coat on borrowings must also change. He further goes on to say that interest rates also change the value of assets and liabilities thereby changing the financial institutions net worth thus impacting on both the balance sheet and the statement of income and expenses of financial firms. As a way of managing interest rate risk he proposes that banks form the asset liability committee (ALCO) and a well run asset liability committee meets regularly to manage financial firms interest rate risk and other exposures as well and is expected to have a firm grasp of the organisation principal goals usually centred on the maximisation of shareholders wealth, maintaining adequate profitability and achieving sufficient capitalisation. He further goes on to say that

the Asset liability committee estimates the firms risk exposure to its net interest margin and net worth ratios ,develops strategies to keep that risk exposure within well-defined limits and may employ simulation analysis to test alternative management strategies.

In addition to the above, Rose (2010) also argues that interest sensitive gap management can also be used to manage interest rate risk and this technique requires management to perform an analysis of the maturities and repricing opportunities associated with interest bearing assets and liabilities. If management feels its institution is excessively exposed to interest rate risk, it will try to match as closely as possible the volume of assets that can be repriced as interest rates change with the volume of liabilities whose rates can also be adjusted with market conditions during the same period for example a financial institution can hedge itself against interest rate changes no matter which way interest rates change by making sure for each time period that the amount of the interest sensitive assets is the same amount of interest sensitive liabilities.

In this case, the revenue from earning assets will change in the same direction and proportion as interest cost on liabilities.

Hennie and Sonja(2003) , in their analysis this approach contend that it aims at allocating assets and liabilities to maturity 'buckets', defined according to their repricing characteristics and to measure the gap at maturity point. They further argue that in a gap model, the components of the balance sheet are separated into items that are sensitive to interest rates and those that are not. These are in turn sorted by the repricing period (modified period) and allocated to time periods or maturity buckets.

However according to Oracle financial services (2008), GAP management as a method of managing interest rate risk has its own limitations as highlighted by the oracle financial services as listed below:

Financial institutions in the normal course are incapable of out-predicting the markets, hence maintain the zero GAP.

It assumes that banks can flexibly adjust assets and liabilities to attain the desired GAP.

It focuses only on the current interest sensitivity of the assets and liabilities, and ignores the effect of interest rate movements on the value of bank assets and liabilities.

Duration gap management or duration analysis can also be used to hedge against interest rate risk in banking. According to Rose (2010) this method is used to shelter an institution's net worth from interest rate change he goes ahead to describe duration as a value and time weighted measure of maturity that considers the timing of all cash flows from earning assets and all cash outflows from associated with liabilities. In a related argument, Oracle financial services (2008) states that duration analysis begins by computing the individual duration of each asset and liability and weighting the individual durations by the percentage of the asset or liability in the balance sheet to obtain the combined asset and liability duration. The application of duration analysis requires extensive data on the specific characteristics and current market pricing schedules of financial instruments. However, for institutions which have a high proportion of assets and liabilities with embedded options, sensitivity analysis conducted using duration as the sole measure of price elasticity is likely to lead to erroneous results due to the existence of convexity in such instruments. Apart from this, duration analysis makes an assumption of parallel shifts in the yield curve, which is not always true. To take care of this, a high degree of analytical approach to yield curve dynamics is required. However, immunisation through duration eliminates the possibility of unexpected gains or losses when there is a parallel shift in the yield curve. In other words, it is a hedging or risk-minimisation strategy; not a profit-maximisation strategy.

It's however important to note that with the increasing financial innovation in the banking industry, a new range of financial products or instruments have been created which can also be used to manage interest risk such as interest rate swaps, futures, options and customised agreements to alter the balance sheet risk exposure.

Interest rate swaps (IRS) for example represent a contractual agreement between a financial institution and counterparty to exchange cash flows at periodic intervals, based on a notional amount. The purpose of an interest rate swap is to hedge interest rate risk. By arranging for another party to assume its interest payments, a bank can put in place such a hedge. Financial institutions can use such swaps to synthetically convert floating rate liabilities to fixed rate liabilities. The arbitrage potential associated with different comparative financing advantages (spreads) enables both parties to benefit through lower borrowing costs.

In case of a falling interest rate scenario, prepayment will increase with an attendant shortening of the asset's average life. The financial institution may have to continue exchanging swap cash flows for a period longer than the average life of the asset. In order to protect such situations, options on swaps or 'swaptions' may be used. Call options on swaps allow the financial institution to call the swap, while put options on swaps allow the institution to activate or put the swap after a specific period.

According to Rose (2010), financial futures contract can also be used to hedge against interest rate risk he defines it as an agreement reached today between a buyer and a seller that calls for delivery of a particular security in exchange for cash at some future date. Financial features trade in futures market and are usually accounted for as off-balance sheet items on financial statements of financial firms. The financial futures market are designed to shift the risk of interest rate fluctuations from risk averse investors such as banks and insurance companies to speculators willing to accept and possibly profit from such risks. He further

argues that features contract work through use of short and long hedges where short hedges are used especially when a bank suspects that interest rate are likely to rise hence lowering the value of any bonds or fixed rate loans that a financial institution may hold or expect to buy and long hedges is when a financial firm wishes to hedge its self against falling interest rates especially when cash flows are expected to fall in the near future. He concludes his argument by affirming that the use of long and short hedges is basically done to protect income and value of the firm as the three most typical interest rate hedging problems most financial firms face are (1) protecting the value of securities and fixed rate loans from losses due to rising interest rates, (2) avoiding a rise in borrowing costs, and (3) avoiding a fall in the interest returns expected from loans and security holdings. Therefore the most appropriate hedging strategy using financial features is: avoiding higher borrowing costs and declining asset values by using short (or selling) hedge and avoiding lower than expected yields from loan and security investment by use of a long(or buying)hedge

Where a financial institution face a positive interest sensitive gap it can protect itself against loss due to falling interest rates by covering the gap with a long hedge of approximately the same dollar amount as the gap. On the other hand if the institution is confronted with a negative interest sensitive gap, it can avoid unacceptable losses from rising market interest rates by covering with a short hedge approximately matching the amount of the gap.

Section 60 (2) of the FIA (2004) requires financial institutions to establish limits on the sensitivity of the net interest income to changes in interest rates as well as a maximum percentage imbalance between interest rate sensitive assets and liabilities and by doing so interest rate risk can be managed

2.4.3 Liquidity risk management

Hennie and Sonja (2003) assert that liquidity is necessary for banks to compensate for expected and unexpected balance sheet fluctuations and to provide funds for growth they further go on to say that it represents a bank's ability to efficiently accommodate the redemption of deposits and other liabilities and to cover funding increases in the loan and investment portfolio. It is for such a reason that they contend that liquidity risk management lies at the heart of confidence in the banking system as commercial banks are highly leveraged institutions and liquidity shortfall at a single institution can have system wide repercussions.

Liquidity risk management is also important because it is in a way linked to other area of risk management such as credit risk management. This is emphasized in Sec 29 of the FIA(2004) which states that where a financial institution fails to maintain the minimum amount of liquid assets it shall not grant any new or additional loan or credit accommodation to any person without the prior written approval of the Central Bank. This

According to BCBS (2008), the fundamental role of banks in the maturity transformation of short-term deposits into long-term loans makes banks inherently vulnerable to liquidity risk, both of an institution-specific nature and that which affects markets as a whole.

According to Darling consulting group (2013), managing liquidity risk has become very challenging as balance sheets have grown in complexity and dependence upon the capital markets for funding continues to rise. They further argue that just like with every other aspect of the Asset liability management process, the liquidity risk management process must be clearly communicated and evaluated by your Asset Liability Committee (ALCO) and Board of Directors. The ALCO and the Board should be overseeing liquidity management strategies, policies and procedures on an annual basis and senior management should ensure

that liquidity policies and procedures are clearly outlined with the appropriate risk measurement and reporting systems are in place coupled with reported profile to the Board. They further go on to identify the six steps each institution can take to strengthen their liquidity and liquidity-risk-management process namely; determining ting the how much liquidity it has, estimating how much liquidity is needed, establishing an early warning system, stress testing your funding needs and availability, outlining management responses and documenting your process and periodically testing liquidity sources. All these steps can help improve the manage liquidity risk as well as well improve the overall performance of the bank

Barfield and Venkart (2009) propose that the tenor of banks' funding also needs to be diversified as a way of managing liquidity risk. They build this argument by suggesting that banks should stagger their sources of lending to avoid having to make too many debt repayments at any one time. They however argue that utilising a multiplicity of sources will drive up the cost but a failure to diversify may ultimately result in a far higher price being paid. Moreover, by using a wider range of lending sources and by being transparent about those sources banks can help regenerate confidence.

According to principle ten of the BCBS (2008), another way a bank can manage liquidity risk is by conducting stress tests on a regular basis for a variety of short-term and protracted institution-specific and market-wide stress scenarios (individually and in combination) to identify sources of potential liquidity strain and to ensure that current exposures remain in accordance with a bank's established liquidity risk tolerance. The stress test outcomes should therefore be used adjust its liquidity risk management strategies, policies and positions and to develop effective contingency plans. The committee further stresses that the results of stress tests should also play a key role in shaping the bank's contingency planning and in

determining the strategy and tactics to deal with events of liquidity stress hence making stress testing and contingency planning closely intertwined.

According to BCBS (2008) principle three, senior management should develop a strategy, policies and practices to manage liquidity risk in accordance with the risk tolerance and to ensure that the bank maintains sufficient liquidity. Senior management should continuously review information on the bank's liquidity developments and report to the board of directors on a regular basis. A bank's board of directors should review and approve the strategy, policies and practices related to the management of liquidity at least annually and ensure that senior management manages liquidity risk effectively. In relation to this section 6 (3)of the Financial Institutions (Liquidity) Regulations, 2005 in Uganda states that the Board of Directors of a financial institution shall, in accordance with section 60 of the Act, constitute an Asset and Liability Management Committee (ALCO) which shall establish broad guidelines on the financial institution's tolerance for risk, and whose responsibilities shall include managing the overall liquidity of the financial institution.

In relation to the above, Section 6 (2) of the Financial Institutions (Liquidity) Regulations, 2005 in Uganda stresses that a financial institution shall have an articulated and specific management as good management information systems, central liquidity control, analysis of net funding requirements under alternative scenarios diversification of funding sources and contingency planning.

Another means by which banks can manage liquidity risk as stipulated in principle seven of the BCBS (2008) is by establishing a funding strategy that provides effective diversification in the sources and tenor of funding. It further goes on to stipulate that banks should maintain an on-going presence in its chosen funding markets and strong relationship with fund providers to promote effective diversification of funding sources. Principle eleven further

builds the aspect of funding by agitating for banks to have formal contingency funding plans (CFP) that clearly sets out the strategies for addressing liquidity short falls in emergency situations .It goes ahead to sat that a contingency funding plan should outline policies to manage a range of stress environments ,establish clear lines of responsibility, include clear invocation and escalation procedures and be regularly tested and updated to ensure that it is operationally robust

It can therefore be concluded that liquidity risk management is relevant because liquidity because a liquidity is important is important to functioning of the of the banking sector and a liquidity shortfall at a single institution can have system wide repercussions

2.4.4Foreign Exchange risk management

According to Santomero and Babbel (2003) banks can manage this risk by making sure assets and liabilities are denominated in the same currency. In addition to this off balance sheet activities such as currency swaps and forward rate agreements that restore the balance and reduce the exposure to foreign exchange risk. They describe currency swaps as a part of simultaneous spot and forward transactions in which the forward transactions offset the spot transactions.

In Uganda Section 41(1) of the FIA (2004) states that a financial institution shall not conduct any new foreign exchange business if it is significantly undercapitalised. This can also serve as measure against managing foreign exchange risk.

On the other hand Section 42 the FIA (2004) places restrictions on foreign exchange exposure to restrain banks from taking on excessive risk resulting from over exposures to foreign currencies and this shall not exceed twenty five per cent of the financial institutions core capital so as to prevent any foreign exchange risk

2.4.5 Operational Risk management

According to principle one of the BCBS (2011), the board of directors should take the lead in establishing a strong risk management culture. The board of directors and senior management should establish a corporate culture that is guided by strong risk management and that supports and provides appropriate standards and incentives for professional and responsible behaviour. In this regard, it is the responsibility of the board of directors to ensure that a strong operational risk management culture exists throughout the whole organisation. The committee therefore emphasizes that banks with a strong culture of risk management and ethical business practices are less likely to experience potentially damaging operational risk events and are better placed to deal effectively with those events that do occur. This in the view of the researcher is an essential element in fostering the good performance of banks because the board and senior management together with the policies, processes and systems they formulate provide an essential foundation for instilling a sound risk management culture in the organisation.

According Sec 55(1) part b and c, of FIA (2004) the board of directors of a financial institution shall be responsible for ensuring that the board is in full control of the affairs and business operations of the financial institution and ensuring that the business of the financial institution is carried on in compliance with all applicable laws and regulations and is conducive to safe and sound banking practices by doing so a bank can manage risks inherent in its operations

2.5 The Relationship between risk management and the performance of financial Institutions.

According to Campion (2002), the need to reduce business losses for firms is a major reason for their involvement in risk management .She supports this argument by saying that strong internal controls which are integrated in the risk management frame work of a firm will help

in reducing fraudulent acts as well as promoting efficiency which are crucial in reducing losses thus justifying the relationship between risk management and the performance of financial institutions.

On the other hand Rose (2010) asserts that the rapid expansion of international finance around the globe has not only opened up new service markets but also increased financial firms exposure to risk due to volatile foreign market conditions, changing government rules and sometimes political instability overseas. This has therefore made risk management an essential element in the performance of commercial banks. In related view Santomero and Babbel (2003) argue that banks have become increasingly global.

The relationship between risk management and performance of financial institutions according to Casu et.al (2006) is evident in what they describe as CAMEL ratings .These are summarised as adequate capital(C), good asset quality (A), competent management (M), good earnings (E), sufficient liquidity (L), and sensitivity too market risk(S).It is therefore important to note banks with proper risk management are able to achieve good CAMEL ratings which signifies good performance.

The net interest margin can also be used to determine the relationship between risk management and performance of financial institutions. According to Casu et.al (2006) it measures the net interest income relative to the bank's total or earning assets. If management of a bank find that a particular net interest margin is acceptable, it will probably use a variety of interest risk hedging methods to protect this NIM value, thereby helping stabilise net earnings hence better performance (Rose.2010).

NIM = [(interest income -interest expense)/ total assets]

The return on assets also determines the relationship between risk management and performance of financial institutions. According to Rose (2010) this is a primary indicator of

managerial efficiency and it indicates how capable management has been converting net assets into net earnings .This however calls for proper asset management which according to Casuet.al(2006)and this entails maximising returns on loans and other securities for example increasing loan screening and monitoring actions and by choosing low credit risk/high return customers. To achieve the desired performance relation to return on assets a financial institution needs to have a well-defined risk management strategy hence ascertaining the relationship between the two.

ROA = Net income/Total assets

The relationship between risk management and performance of financial institutions is also envisaged in the value of the stock of the firm. It's important to note that risk management is a component of financial management which has its basic principles in attempting to maximise a corporation's stock value as priority over all others. The value of a financial firm's stock value will tend to rise if the financial organisations perceived level of risk falls due perhaps due to an increase in equity capital, a decrease in its loan losses, or the perception of the investors that the institution is less risky overall due to strategies like diversification of service offerings and expansion in the number of markets being served Rose (2010).This justifies the relationship between risk management and the performance of financial institutions because it's essential in determining the value of the firms stock which is a performance indicator.

Return on equity can also be used to establish the relationship between risk management and the performance of financial institution. According to Rose (2010) is a measure of the rate of return flowing to shareholders and it approximates the net benefit that the stock holders have received from investing their capital in the financial firm. It is therefore important that the

managers of financial institution properly manage the risk the organisation is exposed to so as to realise higher returns for shareholder which is a measure of good performance.

ROE= Net income/Total equity capital

To establish the relationship between risk management and the performance of financial institutions, the ratio of nonperforming assets to equity capital can also be looked at. Non-performing assets are income generating assets, including loans that are past due for 90days or more. It is therefore important to note that increase in this ratio signals failure of a lending institution due to increased credit risk exposure hence bad performance and a sign of poor risk management.(Rose 2010).

2.6 Conclusion

This chapter has discussed the clearly the major risks faced by financial institutions, how they are managed and the relationship between risk management and the performance of financial institutions.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents the research methods that were used in the study. The research design, the target population, the sample size and sampling techniques, the data collection method, data instruments and tools, data analysis techniques, ethical considerations, limitations of the study and the conclusion.

3.2 Research design

Kumar (2011) defines a research design as a plan, structure or strategy for investigation or arrangement of conditions for data collection and data analysis. On the other hand Van Myk(2013) defines a research design as an overall plan for connecting conceptual research problems to the pertinent empirical research. He further argues that it articulates what data is required, what methods are going to be used to collect and analyse this data and how all this is going to answer your research questions.

The study was a descriptive cross-sectional case study based on examining the effect of risk management on the performance of financial institutions in Uganda. It involved both quantitative and qualitative techniques of data collection. It covered the period of 2011-2013. The methods used, facilitated the collection of the empirical data required for the study. The sources of data include; documents, financial statements, work plans and other materials used in risk financial management in the organization's resources. The managers, accountants, and the tellers were chosen because they are the controllers of the key liquid and non-liquid assets in the organization such as cash.

3.3 Area of the study

The study was conducted at the Ecobank head offices found in the central division of Kampala district with an aim of establishing the impact of risk management on the performance of financial institutions specifically commercial banks in particular Ecobank as the case in question. The targeted population included the management of Ecobank, the staff and customers. The researcher chose Ecobank main branch Kampala because the branch is located in the central heart of commercial businesses, where small and large scale business people operate from and professional jobs in central region. Therefore, the area in which these branch is located is populated with business people who could be stake holders with the Bank and it explains the researcher's substantial choice of the area in order to get access to first hand data from the proper sources who could be observant and involved in the survey.

3.4 Study population

Population refers to the totality of all subjects under investigation (Kakooza.T, 2005).In a related argument refers to population as an entire group of people, events or thing of interest that the researcher wishes to investigate. The study population included the stake holders of Ecobank and the participants in the study were drawn using a purposive sample with a targeted group of 70 respondents. Therefore, it was inclusive of participation of Ecobank management staffs (customer services managers), employees (customer contact employees/tellers), and customers. It covered both genders that is to say males and females at least above the age of eighteen because they are people with the relevant experience and knowledge about Ecobank financial services and possible risks.

3.5 Sample size

According to Bryman and Bell (2003), a sample is a segment of the population that is selected for investigation which is the subset of the population. The study targeted eighty respondents from the main branch of Ecobank as a sampling size. The seventy respondents

from the main branch was adequate size for sampling due to scarcity of resources in terms of finance risks and limited time available for the study. With the use of purposive sampling procedure, there were 70 people who were taken as respondent (sample size) out of estimation of 80 people (population size). However out of the 80 questionnaires that were distributed to various respondents 70 questionnaires were received back and were completely filled, 4 were incompletely filled and were discarded whereas,6 were not received back because some respondents were nowhere to be traced ,whereas others seemed not to have time to respond to the questionnaires.

3.6 Sampling procedures

The sampling instruments were constructed and given to the supervisor for approval. The supervisor ascertained the face validity and language of the instrument. Changes were made as recommended by the supervisor. After the approval, the researcher went to the field. Using the authority letter from the University, the researcher introduced himself to the bank authority to seek permission to sample the employees and customers of the bank. The researcher explained the purpose of the research and its benefits to the bank and to the customers. The researcher assured the respondents of confidentiality in relation to the information they provided. The researcher then distributed the questionnaires to the selected respondents and collected them later on.

3.7 Sampling techniques

The researcher deployed both qualitative and quantitative sampling strategies in data collection. In the quantitative strategy, the researcher depended on random sampling technique sometimes called probability random sampling. The rationale for this was to give at least each respondent a chance to be in the sampling. This was conducted specifically on the big number of customer respondents. The researcher also went ahead to administer questionnaires purposefully. This was carried out specifically on service customer managers

and the customer contact service employees (tellers). The researcher chose those respondents purposely, because they were the most likely updated informants with the correct and relevant desired information.

3.8 Data Collection Methods and Instruments

Cooper and Schindler (2006), define data as the facts presented to the researcher from the study's environment. Oso and Onen (2008) also define data as anything given or admitted as a fact and on which a research inference is based.

3.8.1 Questionnaires

Questionnaires were implored in the data collection. Both structured and open ended questionnaires were relevantly used in the study. Oso and Onen (2008) define a questionnaire as a data collection technique where items or questions are formulated to which a respondent is expected to react in writing. Bryman and Bell (2003) state that with self-administered questionnaire, respondents answer questions by completing the questionnaire themselves. Structured questions were formulated with answers which only required the respondents to put a tick or circle on what they thought was the right opinion. The structured questionnaires were liker scaled questionnaires in nature with a multiple choices to pick on. The researcher chose the structured format because the researcher wanted the respondents to keep within the realm of the relevance of the research.

In addition, open ended questions were relevantly used in the data collection. The intention was to give a chance to respondents to expresses their views on certain issues as regards the problem under study. In general, the use of the questionnaires allowed confidentiality and anonymity of the respondents, allowed enough time for the respondents to think about the questions and answers, and most of all they were less time consuming to the researcher and

respondents. After all the responses had been collected, the data was analysed in the findings and discussed in chapter four of data analysis, presentation and discussion.

3.8.2. Interview guide

The researcher also used an interview guide to collect the relevant data. The interview guide was structured in nature. The researcher asked specific questions in line of the objectives of the study to the respondents. Later on, the researcher filled in the answers as being told by respondents (Kvale&Brinkmann, 2009; Mugenda&Mugenda, 1999). The reason for the interview guide was that the interview permitted greater depth of response and further it permitted the researcher to ask the respondents thoroughly and explain a given response in connection to the research under study

3.8.3 Observation

The researcher took another initiative to use observation as another method for collecting the data. This is a method in which a person observes what is occurring in a real life situation, recording what is happening. The researcher created a rapport with the customers as the researcher observed their responses and their body language. Thereafter, the researcher noted down some observant behaviour in the realm of the research guide line objectives.

3.8.4 Library research

It was inevitable for the researcher not to visit the library for consultancy in the research work. Various text books, journals, articles, Newspapers in the library were consulted. Also in order to substantiate especially the literature review, the researcher dwelt much on visiting the libraries to get the relevant information needed for the research progress.

3.9 Quality Control Methods

Oso and Onen (2008) assert that controlling data quality entails ensuring acceptable levels of validity and reliability of instruments In order to ensure quality control of the questionnaires

administered not to have errors and incompleteness, the researcher succumbed to the' following measures below; The researcher kept around ensuring that the questionnaires that were administered were properly monitored. Therefore, the researcher kept on making frequent checks on the respondents to see that they were on the right track. The researcher also availed some ample time to those respondents who needed guidance in filling the questionnaires and to explain to them what to do with the questionnaires

3.9.1 Reliability and Validity

According to Amin (2005), ***reliability*** is dependability or trustworthiness and in the context of a measuring instrument. It is the degree to which the instrument consistently measures whatever it is measuring. Amin also defines ***validity*** as the ability to produce findings that are in agreement with theoretical or conceptual values. According to Oso and Onen (2005), ***validity*** is the extent to which research results can be accurately interpreted and generalized to other populations. Therefore, it is the extent to which research instruments measure what they are intended to measure. The reliability and validity of the methods was determined by the use of two methods that is split half and pretesting/piloting methods in order to allow the researcher get actual facts to solve the problem under study. Split half method involved dividing the total number of questionnaires into two halves where the first half of the questionnaires was distributed. They were then retrieved from the field and then analyzed. Then there after the second half was distributed as well, retrieved and then analyzed. The pre-test method was used to see how accurate the responses in the questionnaires were. The validity was pre-tested using the coefficient of validity index (CVI).

$$CVI = \frac{\text{Items rated relevant}}{\text{Total number of items}} \times 100\%$$

In order to control quality, the researcher endeavored to attain validity and reliability coefficient of at least 0.70 or 70% but if it was below that, then the data would not be valid or reliable.

3.10 Data Management and Processing

After the data had been collected from the field, the researcher went through all the questionnaires to check for completely and incompletely filled questionnaires. The incomplete filled questionnaires were discarded and the completely filled questionnaires were retained and were given numerical numbers for easy editing and coding. Only the properly coded questionnaires were used to analyze the data findings in next chapter four.

3.11 Data analysis

Data analysis according to Oso and Onen (2008), is the organization, interpretation and presentation of collected data. Data analysis entails separation of data into constituent elements or an examination of data to distinguish its component elements separately and in relation to the whole. That is, descriptive analysis and inferential analysis. The collected data was analyzed using both quantitative and qualitative methods. The researcher used frequency analysis method to the data collected. The responses from the questionnaires were coded and were expressed in frequency and percentage respectively. The frequency results were expressed in percentage which illustrated the respondent's opinions on a specific issue in a questionnaire. The results showed that the higher the greater percentage of responses, the higher the seriousness of an issue to the respondents. According to Burns and Burns (2008), correlation refers to a measure of the degree of correspondence between variables. It can either be a positive correlation where an increase or decrease in one variable coincides with an increase or decrease in another variable. It can also be a negative correlation where one variable increases or decreases as the other variable decreases or increases.

Inferential analysis is used to draw conclusions concerning the relationships and differences found in research results. (Oso and Onen, 2008). The researcher used correlation as the statistical tool in this case. Therefore, there searcher looked at the relationship between the attributes of the independent variables that is; credit risk management, operational risk management, liquidity risk management, foreign exchange risk management and the attributes of the dependent variables which include; increase in return on assets, decrease in the ratio of non-performing loans to total loans, increase on return equity, reduced operating costs, increase in net interest margin

3.12 Ethical consideration

Oso and Onen (2008) note that, despite the high values of knowledge gained through research, knowledge cannot be pursued at the expense of human dignity. The researcher therefore paid extra attention to the ethical considerations while in the field so as to be able to get the information that was needed to compile the research report. The major ethical considerations included; informed consent, privacy and confidentiality, anonymity and researchers' responsibility.

- The researcher first obtained permission from the University by acquiring the recommendation from the faculty of business administration and management and the institution she was to carry out the research from. The researcher also had to obtain permission from the potential respondents before the real activities of data collection took place. Not all data collected is lawful or based on known statements, events and conditions. Therefore the researcher had to collect data for which consent was obtained and was relevant to the research.

- The researcher made an attempt to handle the information given by the respondents as strictly confidential as possible by guarding the privacy which was one of the primary responsibilities.
- The researcher did not ask for the identity of the respondents like their names and where they come from. The researcher requested the respondents to kindly answer the questionnaires willingly and out of free will.
- The researcher also avoided deceptions in the process of research. The researcher was honest and trustworthy while explaining the objectives and procedures of the study so as to get the necessary information from the respondents.

3.13 Study Limitations

Limitations refer to hindrances or anticipated constraints imposed on the methodology of the study. Oso and Onen (2008). They assert that limitations should be identified because they partly define the scope of the study and provide the necessary precautions during data interpretation and generalization of results. Limitations can lower the reliability and validity of the data collected. The researcher therefore encountered the following limitations while in the field and during the whole research.

- ➢ The time allocated for the research was not enough which made the researcher work under pressure. If the time was enough, the researcher would have used a bigger population sample. In this case, the researcher prioritized the available time so as to complete the research report in time
- ➢ There were limitations in funding of transport and materials for the researcher as not all the available data would be got from the proposed case study and this was avoided by soliciting for fund from well-wishers and relatives.

- It was also expensive for the researcher in terms of making phone calls in order to collect the data for the proposal. This was avoided by having a research assistant who would go to the field to collect the data. Despite all these limitations, the research had to continue obtained sufficient information needed in the study so as to come up with good findings.

3.14 Conclusion.

The chapter has discussed in depth methodology and the design that were used to collect data. The instruments used, the way of presentation analysis and discussions form the basis on which chapter four will base. Even though there are limitations in the methods of data collection, the chapter has discussed in depth methodology and the design that were used to collect data, analysis and interpretation which will generally result in reliable conclusions. Therefore, the next chapter, the findings from the field, and records based on objectives and questions are presented and analyzed.

CHAPTER FOUR

PRESENTATION, ANALYSIS AND INTEPRETATION OF FINDINGS

4.1 Introduction

This chapter presents data, analysis and interpretation of findings in line with study objectives. The broad focus of the study was to establish the effect of risk management on the performance of financial institutions in Uganda (Ecobank Uganda).However emphasis was put on identifying the different kinds of risk faced by financial institutions, how they are mitigated and establishing the relationship between risk management and performance of financial institutions.

4.2 Demographic Information of Respondents

The following demographic information was considered relevant to the study gender of the respondents, age of respondents, marital status, number of years served and position held in the organization. The results of the demographic characteristics are presented as follows.

4.2.1 Gender Distribution

The sample included 70 primary respondents who are working in different departments of Ecobank Table 1 below illustrates the composition of respondents:

Table 1: Showing the Distribution of Respondents by Sex

Sex	**Frequency**	**Percent (%)**
Male	37.7	53.8
Female	32.3	46.2
Totals	70	100

Source: Research data, 2014

According to table 1 above, majority of the respondents were male (53.8%) and female respondents were 46.2%. There was however almost an equal representation of both the male and female since the margin between the two sexes (almost 7.6%) is minimal. Views were therefore equally represented by both the male and female employees of Ecobank. That helped the researcher to obtain adequate information necessary in coming up with the findings.

4.2.2 Age

Table 2: Shows the description of respondents by Age (Eco bank)

Age	Frequency	Percent (%)
18-25 years	4	5.7
25-35 years	56	80
35-70 years	10	14.3
Totals	70	100

Source: Research data, 2014

Table 2 shows that out of 70 respondents, the age group of 25-35 years had the highest representation (80%). The least representation was of the age group 18-25 years (5.7%). This implies that most staffs of Eco bank are in the middle age young and dynamic for good performance of the organization in terms of profitability when maximized well and they can help in risk management.

4.2.3 Number of years served in Ecobank

The findings in the table below show the responses regarding the number of years served by respondents in Ecobank.

Table 3: Working experience of respondents

Number of years	Frequency	Percent (%)
< 1 year	10	14.3
2-5years	45	64.3
5 years and above	15	21.4
Total	70	100

Source: Research data, 2014

Table 3 shows that most of the respondents have 2-5 years working experience at Ecobank (64.3%). This implied that most respondents at Ecobank have between 2 to 5years experience. This is an indication that the rate of staff turnover is low and this experience can help the organization in managing it financial risks.

4.3 Major risks that affect financial institutions' performance

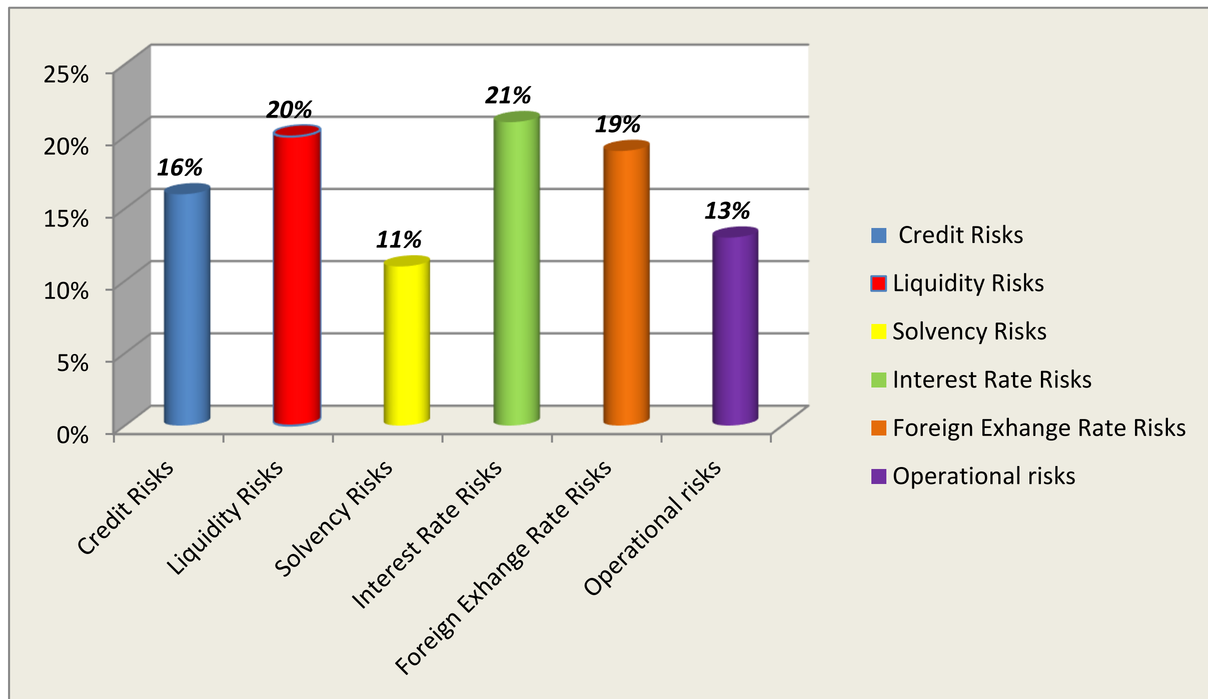
Ecobank is one of a steadily growing financial institution in Uganda. And like any other financial institution in the banking industry it faces risk both from within and outside the organization which have potentially adverse effect on the performance of the bank. The question was asked the respondents on the major risks that affect the performance of an organization and following where the responses as shown on table 4 below:

Table 4: Showing the various Risks (Ecobank)

Risks	Frequency	Percentages (%)
Credit Risks	11	16
Liquidity Risks	14	20
Solvency Risks	8	11
Interest Rate Risks	15	21
Foreign Exchange Rate Risks	13	19
Operational risks	9	13
Total	**70**	**100**

Source: Research data, 2014

Figure 3:Line Graph showing the types of risks faced by financial institutions



Source: Research data, 2014

According to the figure 2 above it is clearly shown that the bank faces high interest rate. The 20% of the respondents agreed Liquidity risk as one of the major risks that affect the performance of an organization because it is financial risk due to uncertain liquidity the organization lose liquidity if its credit rating falls, and it experiences sudden unexpected cash outflows, or some other event causes counterparties to avoid trading with or lending to the institution. The organization is also exposed to liquidity risk if markets on which it depends are subject to loss of liquidity there the management has to be very keen. The 20% of the respondents agreed that interests' rates do affect the performance of an organization

Since Interest-rate risk is the risk, taken by bond investors, and the rates rise after they buyorthat a bond's yield will rise (as its price falls) after it has been purchased hence affecting the organisationsprofits. However 19% of the respondents believed that foreign exchange rate

risk affects the financial institutions performance since it is a risk which is attached to the value of one's assets when it is valued in another currency. On the other hand credit risk with 16% of the respondent attaching it as one of the key factor risks that affect the performance of an organisation. Lastly operational 13% and solvency risk 11% do agree that these risks affect the performance of the organisation. Therefore the management of the financial institutions have a responsibility of ensuring that all the above risks are critically looked at with maximum attention if the organisation is operate more effectively and efficiently.

4.3.1 Knowledge and training on risk management

The researcher ascertained from the interviews with the respondents that (100%) of the them had knowledge on the risk management and its effect on performance of an organization. The question on training of staff on risk management was asked the respondents and 82.9% of the respondents had attained training in risk management on different aspects such as risk rating, credit risk management, operational risk management, market risk and compliance risk management whereas other respondents had also acquired training through various courses and seminars such as ACCA among others .This knowledge attained by half of the respondents helped in ensuring that the staff are well equipped to handle the various financial risks ,However 17.1% of the respondents had not attained any specific training relating to risk management, this percentage calls for management attention to ensure that they too are taken for some training because this number though small it may be but it can cause losses to the organization.

4.3.2. Exposure to the different risks

All the respondents agreed that the bank was exposed to the various kinds of risks given the nature of their business namely credit risk, liquidity risk, interest risk operational risk and foreign exchange risk. Other types of risk identified by some of the respondents include strategic risk, compliance risk The respondents also confirmed that the bank had experienced

a financial risk and among the major causes include failure or lapses of internal controls, fraudulent acts by staff, poor information systems for reviewing and monitoring risk which according to Hennie and Sonja (2003) are classified under operational risk and can result into losses since they arise from internal process of the organization. Another major issues identified by the respondents was noncompliance or reluctance in implementing already existent policies and procedure and mismatch of assets and liabilities. This exposes the organization to high risks if these factors are not taken caution of in time.

4.4 How the bank manages the different risks

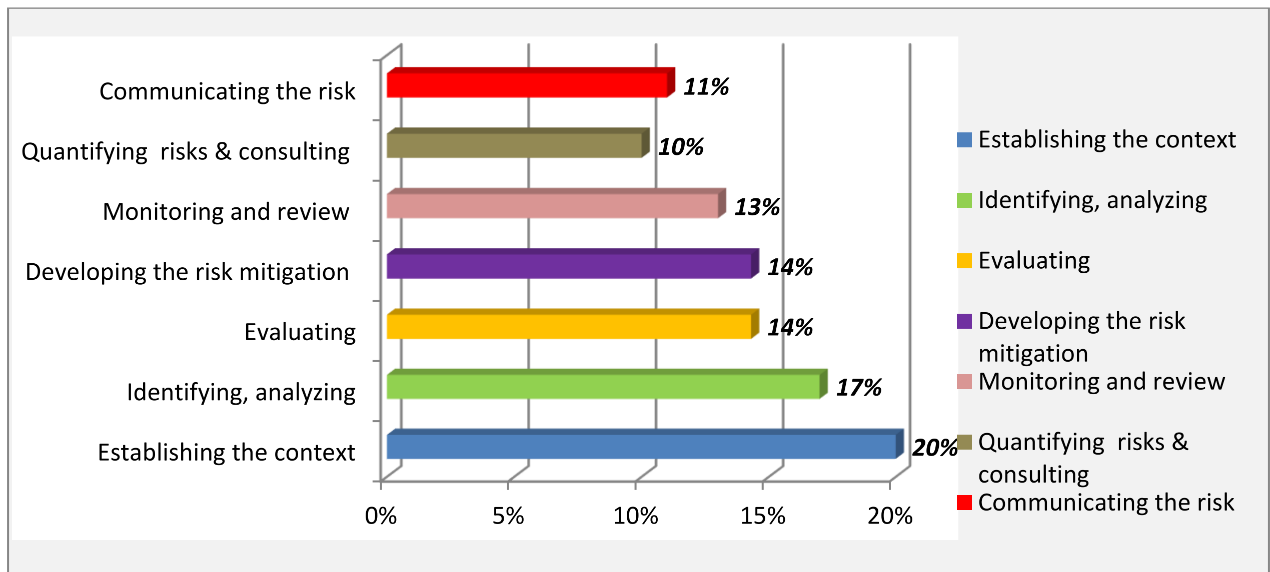
Risk management is an ongoing process and according to (SBP, 2003) it involves identifying, measuring, monitoring and controlling risk to ensure that the individual clearly understands risk management and fulfills the business strategy and objectives. All the respondents in the study identified the process of risk management as one which involves establishing the context, identifying, analyzing, evaluating, developing the risk mitigation strategy, monitoring and review of the strategy, quantifying the risks and consulting and communicating the risk.

Table 5: Showing the management of various risks (Ecobank)

	Frequency	**percent (%)**
Establishing the context	14	20
Identifying, analysing	12	17
Evaluating	10	14
Developing the risk mitigation	10	14
Monitoring and review	9	13
Quantifying the risks and consulting	7	10
Communicating the risk	8	11
Totals	70	100

Source: Research data, 2014

Figure 4: Showing how the bank manage various risks (Ecobank)



Source: Research data, 2014

The bar graph above clearly show that establishing the context of the risk with 20% helps in the management of the risks encountered by the banks. The 17% of the respondents agreed that identifying and analyzing of the risk at its earliest stage helps in reducing its negative effect on the performance of the organization. The evaluation and development of the risk mitigation (14%) asserts that this helps in the management of risks faced by the organization. The 10% do agree that communication of these risks to various heads of departments help in the minimization of their occurrences. Quantification and consultation (10%) of the respondents consider this as a key element which the management should take keen interest on. Therefore, the management of the organization is charged with the responsibility of ensuring that the above factors are followed as a way of minimizing these risks with affect the performance of the organization.

4.4.1Analysis of strategies used to mitigate the risks

Table 6: Showing the Strategies used to mitigate risks

Strategy	**Frequency**	**Percent (%)**
Credit derivatives	10	14.7
Liquidity stress testing	18	25.7
Futures contracts	8	10.3
Securitization of Assets	17	24.3
Swap agreements	6	8.8
Gap analysis	11	16.2
Totals	**70**	**100**

Source: Research data, 2014

Table 4 shows that the most commonly used strategies used to mitigate risks were Liquidity stress testing (25.7%).Liquidity stress testing is done to find out the institution has the minimum amount of liquid assets to enable it extend credit to its clients. In addition to this, Section 29 of the Financial institutions act 2004 states that where a financial institution fails to maintain the minimum amount of liquid assets it shall not grant any new or additional loan or credit accommodation to any person without the prior written approval of the Central Bank this further emphasizes the need for carrying out stress tests as a way of mitigating risk. This however does not imply that other strategies identified such as securitization assets(24.3%), Gap analysis(16.2%),futures contracts(10.2%) and swap agreements are not used because banks are faced with very many risks which necessitates use of these strategies. Therefore, if the financial institutions use keenly this strategy then they have high chances of avoiding this risk which may affect their performance.

4.4.2Factors affecting formulation of risk management policies and how the policies are implemented

The respondents identified the following factors as having affected the way the organization formulates its risk management policies among which included technological advancement, the global bank crises, increased competition among banks, growth in the banking sector, legal and bank regulations. The respondents also specified other factors such as the banks group guidelines as key in determining the way the bank formulates is risk management framework and policies. In regards to implementation of the formulated polices, 40% of the respondents identified the use of Risk control self-assessment (RCSA) as the most commonly used approach though they went ahead to state other methods used to implement the policies such as staff training and sensitization, having monthly risk unit meetings, emphasizing the risk based approach in doing work and use of centralized and decentralized approaches where all units manage risks in their areas.

4.4.3 Critical success factors to risk management

The following were the critical key success factors to proper risk management as shown in the table below

Table 7:**Critical Success factors to proper risk management**

Success factor	**Frequency**	**Percent (%)**
Commitment and support from top management	12	17.5
Communication	11	15.2
Culture	9	13.5
Organization structure	10	14.5
Trust	5	6.8
Information technology	12	16.6
Training	11	15.9
Total	70	100

Source: Research data, 2014

According to Table 5 commitment from top management (17.5%) was identified as the most critical key success factor to proper risk management at Ecobank. This implies that for there to be proper risk management in an organization, top management must be fully committed.

4.4.4 Challenges in managing risks

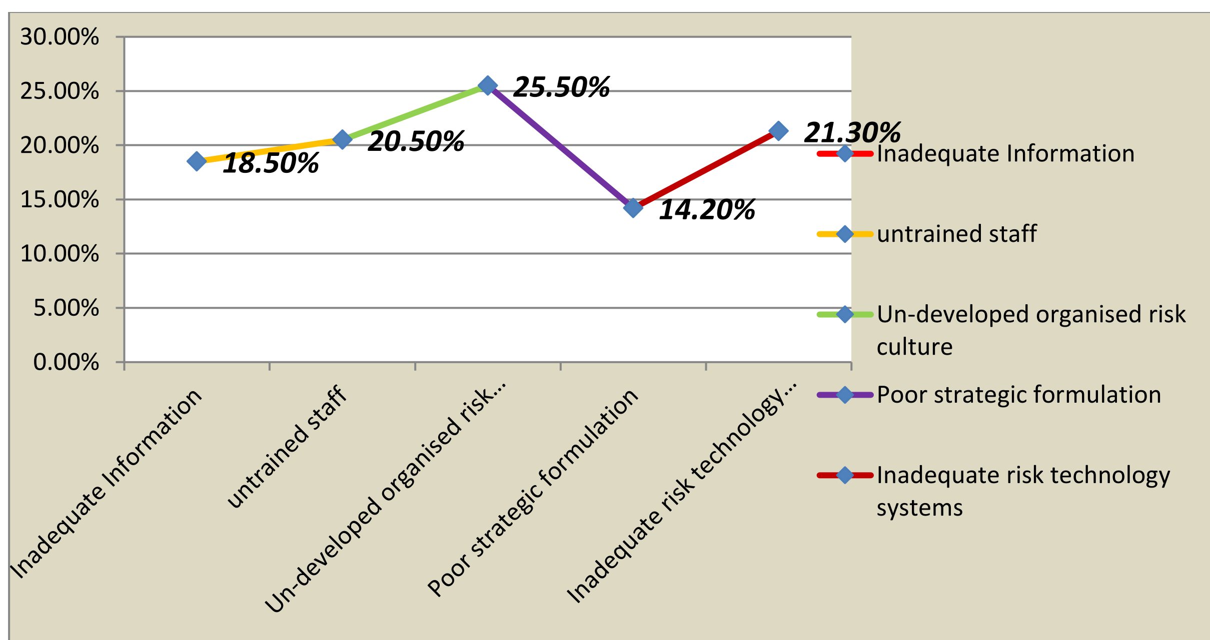
The following challenges were identified by the respondents as challenges in managing risks financial institutions.

Table 8: Challenges in managing risks (Eco bank)

Challenge	Frequency	Percent (%)
Lack of adequate information	12	18.5
Lack of well trained staff	14	20.5
Lack of well-developed organization risk culture	19	25.5
Poor strategy formulation and implementation	10	14.2
Inadequate risk technology systems	15	21.3
Totals	**70**	**100**

Source: Research data, 2014

Figure 6: Showing the challenges encountered by financial institutions (Eco bank)



Resource: Research data 2014

The figure 4 above shows clearly that the lack of a well-developed risk culture (25.5%) was the biggest challenge in managing risk. Michael et.al (2002) emphasize the need to increase the risk culture in an organization through partnership builders sought to engage directly with the business, seeking to position themselves as trusted advisors and partnering overseers looked to influence the business via risk training programs and general awareness-raising activities. It is believed that the former approach involves acting on the capabilities of the risk function and in developing greater business fluency and credibility whereas the latter involves acting on the capabilities of the business itself. The 21.3% of the respondents agreed that lack of technological advancement has also contributed to the increased risk management in banks. This is because the technology is far reaching that the institutions have to train staff on management it. The 20.5% of the respondents state that the untrained staff with limited knowledge on the new ways of management risks has been a great challenge and management needs to take this serious. On the other hand 14% and 18% of the respondents strongly agree this challenges faced by the financial institutions on risk management is due to poor strategic formulation and poor communication. This calls for management attention of being keen on the follow of information.

4.5 The Relationship between Risk Management and Performance of Ecobank

In this section the results that answer the research objectives are presented. The results in the table (Table 7) below were generated using descriptive statistics in order to find out the impact of risk management on the different performance indicators in the organization. Data was analyzed by using descriptive statistics, correlation and regression analyses as shown in the table below to give a clear relationship between the two study variables.

Table 9: Descriptive Statistics for performance indicators

Statements	Strongly agree	Agree	Neutral	Disagree	Strongly disagree	Mean	Std.Deviation
The bank has experienced higher return on equity due to risk management	30.8%	57.7%	7.7%	3.8%	0	3.423	0.702
The bank has experienced increased return on assets due to risk management	30.8%	38.5%	11.5%	19.2%	0	3.423	0.945
The bank's profitability has increased due to risk management	26.9%	53.8%	15.4%	3.9%	0	3.538	0.811
Better quality service due to risk management	26.9%	26.9%	23.1%	23.1%	0	3.538	1.139
Stock value has increased due to risk management	23.1%	61.5%	7.7%	7.7%	0	3.307	0.735
Growth and expansion through risk management	30.8%	42.3%	15.4%	11.5%	0	3.5	0.905
Higher net interest margin due to risk management	46.2%	26.9%	15.4%	11.5%	0	3.346	0.891

Source: Research data, 2014

Table 7 contains the responses of the sampled Ecobank employees on matters pertaining to the different performance indicators of the bank and risk management. Although 88.5% of the respondents either strongly agreed or agreed with the statement that "the bank has

experienced a higher return on equity due to risk management", 3.8% disagreed with the same statement. Regarding the statement "the bank has experienced increased return on assets due to risk management", 69.3% strongly agreed and agreed while 19.2% disagreed with the same statement. On the issue of profitability, 80.7% of the respondents either strongly agreed or agreed with the statement that "the bank's profitability has increased due to risk management", 3.9% disagreed. With the quality of service offered to customers, 53.8%either strongly agreed or agreed that Ecobank was providing better services to its customers because it managed its risk properly whereas 23.1%disagreed. In regards to stock value of Ecobank, 84.6% either strongly agreed or agreed that the bank's stock value has increased due to risk management while 7.7% were in disagreement.73.1% of the respondents strongly agreed and agreed that the bank has been able to grow and expand through risk management while 11.5% disagreed. Finally, 73.1% either strongly agreed or agreed that the net interest margin of the bank has improved as result of risk management whereas 11.5% were in disagreement. Therefore, basing on the above descriptive analysis it can be concluded that many financial institutions have been successful due to effective risk management measures put in place.

Table 10: **Descriptive Statistics for Intervening factors that affect performance**

Statements	Strongly agree	Agree	Neutral	Disagree	Strongly disagree	Mean	Std. Deviation
Changes in technology have affected the performance of the bank	26.9%	42.3%	23.1%	7.7%	0	3.884	0.908
Government and financial regulations have an impact on performance	23.1%	57.7%	19.2%	0	0	4.038	0.622
Competition levels in the banking industry determine how well the bank performs	19.2%	65.5%	11.5%	3.8%	0	3.884	0.908
The level of research and development affects the bank's performance	15.4%	65.4%	15.4%	3.8%	0	3.923	0.688
Prevailing economic conditions determine how well the bank performs	34.6%	57.6%	3.8%	3.8%	0	4.230	0.710

Source: Research data 2014

Table 8 above presents the Ecobank employee responses regarding other aspects that affect the performance of the bank such as technology changes, financial regulations, and level of competition, research and the prevailing economic conditions. 69.2% of the respondents strongly agreed and agreed with the statement that "the changes in technology have affected the performance of the bank" while7.7% disagreed. In regards with the statement "government other financial regulations have an impact on the performance of the bank",80.7% of the respondents either strongly agreed or agreed while 19.2% were 1neutral.84.7% of the respondents strongly agreed and agreed that level of competition in the banking industry determines how well the bank performs while 3.8%disagreed.in regards to the statement " the level of research and development in the bank affects its

performance”,80.8% of the respondents either strongly agreed or agreed while 3.8% disagreed.92.2% of the respondents strongly agreed and agreed that the prevailing economic conditions determines how well the bank performs whereas 3.8% were in disagreement. Therefore, the above Intervening factors affect performance according to various environment factors and the management of the organization has to be enthusiastic in handling them before they go out of hand.

4.6 Conclusion

Risk management has greatly affected the bank’s performance because, had it not been for risk management frame work in place as well as the knowledge which the staff were trained on, the bank would have not been able to withstand the constantly evolving risks and these would have crippled its earnings, public image, good will and general performance which would have led to its poor performance. However, risk management in Ecobank must continue to receive great attention it deserves in order for it to continue steering the bank to great heights and to the interest of its customers and the public at large.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter presents the summary of the findings, conclusions and recommendations for further research with regard to the effect of risk management on the performance of financial institutions. The objectives of the study were to find out the various risks faced by banks, how they are mitigated and to establish whether there's a relationship between risk management and performance of financial institutions

5.2Summary of findings

The risks faced by financial institutions in Uganda

The researcher found out that financial institution especially banks face different types of risks such as credit risk, liquidity risk, foreign exchange risk, interest rate risk and operational risk. This is attributed to the fact that banks provide a myriad of services and involve themselves in many transactions hence being exposed to all these risks. Rose (2010) asserts that the rapid expansion of international finance around the globe has not only opened up new service markets but also increased financial firms' exposure to risk due to volatile foreign market conditions, changing government rules and sometimes political instability overseas. It is also important to note that these risks are interdependent and events that affect one area of risk can have ramifications for a range of other risk categories. This therefore necessitates, that those at the helm of every bank delegate more resources so as to improve each institutions capacity to carry out the risk management process which according to (SBP, 2003) involves identifying, measuring, monitoring and controlling risks.

Strategies used to mitigate risks

The findings show that Ecobank employs different strategies to mitigate the various risks it encounters among which included liquidity stress testing, securitization of assets, Gap analysis,credit derivatives and futures contracts.

Factors that affect formulation of risk management policies

The findings revealed that factors such as technological advancement, the global bank crises, increased competition among banks, growth in the banking sector, legal and bank regulations influence how the bank formulates its risk management frame work and policies. The respondents also identified the banks group guidelines as key in risk management policy formulation. In regards to the implementation of the formulated policy, findings showed that the Ecobank uses risk control self-assessment (RCSA) as the main method when implementing formulated risk management policy

Critical key success factors to proper risk management

The researcher found out that the following factors were critical in ensuring the success of risk management notably commitment and support from top management, information technology, training of staff and communication.

Challenges in managing risk

The findings showed that the lack of a well-developed risk culture at Ecobank was the biggest challenge in managing risk. This implies that if the organization doesn't have a well-established risk culture

The effect of risk management on the performance of Ecobank

The researcher found out that risk management has had an effect on the performance of Ecobank. This is evident in the various performance indicators that the respondents identified as having increased due to risk management such as the return on equity, return on assets, profitability and net interest margin

5.3 Conclusions from the study

The following conclusions are based on the findings from the field study as presented in chapter four.

The relationship between risk management and performance of Ecobank

The research established that there's a strong relationship between risk management and the performance of Ecobank especially with regard to the return on equity, return on assets, profitability and net interest margin. This implies that if a bank properly manages the risks it faces, it will definitely improve on its performance.

Other factors that affect performance

The findings also showed that the performance of Ecobank is not only dependent on effective risk management but also on factors such as changes in technology, government and financial regulations, competition levels in the industry, level of research undertaken and prevailing economic conditions.

5.4 Recommendations from the study

Basing on the research findings in chapter four, the researcher gives the following recommendations;

The bank should put emphasis on developing a strong risk culture in the organization. This can be achieved for example by encouraging all employees to have a shared responsibility in

the risk management process thereby making each individual assume the role of a risk manager guided by the banks overall risk management objectives. It is however important to have clear leadership from senior management by formulating policies procedures.

The bank should also increase the level of risk expertise in all organizational levels and departments this will serve to increase the depth of risk experience in the bank and enable make measured judgments on the level of exposure being taken. Increasing the level of risk expertise can be done by investing in training activities for the staff.

Improving on the level of communication and information sharing should also be encouraged in the bank especially between the risk department and the rest of the organization. This is because any flaws in the communication process can affect the way risk is managed. It is however important that the bank constantly reviews the operations its management information systems as they are key in ensuring proper information flow and communication in the bank.

In accordance with the findings, the researcher observed that in addition to imparting knowledge into the staff of the bank on how to deal with the risks, the same knowledge needs to be imparted into the stakeholders of the bank (customers and shareholders). By so doing, the duty of risk management is also passed onto other parties and this widens the base of the whistle blowers who are observant of all activities while informing relevant authorities of what is happening and thus taking note of risk that would have been overlooked. However, this can be effected through passing on leaflets and booklets to the customers so that they learn how to be risk aware at all times.

The researcher also observed that more investment should be done on information system and technology for easy monitoring of various activities related to risks. This in turn reduces the burden of monitoring the activities in the organization manually which is being carried out by

some few staff. This therefore necessitates the need to install CCTV cameras in sensitivity areas.

5.5Suggested areas for further research

Risk management has today become an indispensible aspect in the banking industry and the financial services sector in general. This is mainly attributed to complex nature of the banking industry compounded with the constant evolution and innovation amidst the strong desire by chief executives to perform better and increase returns. Further research should therefore be doneon:

- How banks can evolve their risk management systems and to handle new risks those arises while carrying out there business and stay relevant.
- The effect of risk management policies on performance of financial institutions in developing countries
- The role of Risk management in the organizational long term strategic plans

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APPENDICES

APPENDIX 1

QUESTIONNAIRE

PART 1

Dear Respondent.

This research is being carried out by Napoko Joseph Paul, an under graduate student at Uganda Martyrs' University. The study is being conducted to analyze the **Effect of Risk management on the performance of Financial Institutions in Uganda (Ecobank Uganda)**. The research is carried out as a partial fulfillment of the requirements foraward of a Bachelor's Degree in Business Administration and Management of Uganda Martyrs' University.

The information provided when answering the questions is for academic purpose only and will be treated with high confidentiality. Your cooperation in answering the questions below is highly valued.

INSTRUCTIONS:

Fill the spaces provided or indicate the response corresponding to appropriate choice of response where applicable.

Section A: BIO DATA

Name of the respondent (optional)--

Sex: Male ☐ Female: ☐ Marital Status: ------------------------------------

Age: 18-25 ☐ 25-35 ☐ 35-70 ☐

1. What is your working experience in this financial institution?

Less than a year ☐

2 to 5 years ☐

Above 5 years ☐

3. Position held.

----

4. Do you have any knowledge about risk management in financial institutions?

Yes ☐ No ☐

5. Do you have any training in risk management and if yes, state the kind of training you attained?

Yes ☐ No ☐

Specify ---

6. For the statements below, select an option that best suits your opinion

Strongly agree 5	Agree 4	Neutral 3	Disagree 2	Strongly disagree 1

	5	4	3	2	1
The organization involves employees when formulating the risk management procedures					
Our organization emphasizes that the element of risk management is upheld in all operations of the various departments					
The risk management process helps the organization towards the attainment of its set goals					
There is a strong risk culture cultivated in the organization					

SECTION B: RISK MANAGEMENT ANALYSIS

*7. What are the risk management procedures**? Tick the most appropriate ones***

a) Establish the context
b) Identify the risks
c) Analyse the risks
d) Evaluate the risks
e) Treat the risks
f) All the above

8. Which of the following challenges does your organization face in managing risks?**The tick the most appropriate ones**

a) Lack of adequate information
b) Lack of well trained staff
c) Lack of well-developed organizational risk culture
d) Poor strategy formulation and implementation

e) Inadequate risk technology systems
f) All the above

Specify others---

9. What are the different kinds of risks faced by your organization? **The tick the most appropriate ones**

a) Credit risk
b) Liquidity risk
c) Interest risk
d) Operational risk
e) Foreign exchange risk
f) Strategic risk
g) All the above

Specify others---

10. Which of the following strategies does your organization use to mitigate the above risks? **Tick the most appropriate ones**

a) Credit derivatives
b) Liquidity stress testing
c) Futures contracts
d) Securitization of assets
e) Swap Agreements
f) Gap analysis
g) All the above

Specify others---

11. Which of the following factors below have affected the way your organization formulates its risk management frame work? **Tick the most appropriate ones**

a) The global bank crises
b) Bank regulations
c) Growth of the banking sector
d) Legal requirements

e) Technological advancement

f) Increased competition among banks

g) All the above

Specify others--

12. How has your organization been able to implement the formulated risk management policies in all areas of business operation?

----

13. How often does your organization evaluate its risk management frame work?

a) Quarterly basis

b) Monthly basis

c) Yearly basis

d) Two years

e) Beyond two years.

14. Is there a specific procedure followed in evaluating the financial risk management frame work?

Yes ☐ No ☐

15. Has risk management had an impact on the following performance indicators in your organization? **Tick the most appropriate ones**

a) Return on Assets

b) Return on Equity

c) Earnings per share of stock

d) Cash accounts to total assets

e) Asset utilization ratio

f) Net interest margin

g) All the above

Specify others

----

16. What are the processes involved in managing a particular risk in your organization?***(Tick the most appropriate ones)***

a) Establishing the context

b) Identifying

c) Analyzing

d) Evaluating

e) Developing the risk mitigation strategy
f) Monitoring and Reviewing the risk mitigation strategy
g) Quantifying the risks and
h) Consulting and communicating the risk
i) All the above

Specify others

----

17. What are the Critical Success Factors to risk management in your organization? ***(Tick the most appropriate ones)***

a. Commitment and support from top management
b. Communication
c. Culture
d. Organization Structure.
e. Trust
f. Information Technology (IT)
g. Training

18. What should effective risk management in your organization include?***(Tick the most appropriate ones)***

a. Ensuring appropriate commitment to risk management
b. Setting clear objectives and guidelines for risk management
c. Allocating adequate resources
d. Training staff appropriately
e. Implementing systems for monitoring and reviewing risks

19. Has your organization experienced any financial risk?

Yes ☐ No ☐

If yes what could have been the causes?

For the statements below, select an option that best suits your opinion

Strongly agree 5	Agree 4	Neutral 3	Disagree 2	Strongly disagree 1

SECTION C: INTERVENING FACTORS

	5	4	3	2	1
Changes in technology have affected the performance of the bank					
Government and other financial regulations have an impact on the performance of the bank					
The level of competition in the banking industry determines how well the bank performs					
The level of research and development in the bank affects its performance					
Prevailing economic conditions determine how well the bank performs					

SECTION B: PERFORMANCE

	5	4	3	2	1
The bank has experienced higher return on equity due to risk management					
The bank has experienced increased return on assets improved due to risk management.					
The bank's profitability has increased as a result of risk management.					
The bank has been able to provide better quality services due to risk management.					
The value of the bank's stock value has increased due to its risk management.					
The bank has been able to meet its growth and expansion through risk management.					
The net interest margin of the bank has improved as a result of risk management					

19. Do you agree that there is a strong relationship between financial risk management and performance of your organization?

Agree ☐ Strongly agree ☐ Disagree ☐ Strongly disagree ☐

20. Give any relevant information which you think has been missed out and it is important in financial risk management on performance of your organization?

APPENDIX II

INTERVIEW GUIDE

1. Do you have any knowledge on risk management?

2. What kind of risks has your organization experienced?

3. What strategies has your organization put in place to mitigate these risks?

4. What are the critical key success factors to proper risk management?

5. What challenges does your organization face in managing the risks it faces?

6. Has risk management had an impact on the performance of your organization?

APPENDIX III

Letter of Introduction

Uganda
Martyrs
University

making a difference

Office of the Dean
Faculty of Business Administration and Management

Your ref.:
Our ref.:

Nkozi, 15th May, 2014

To Whom it may Concern

Dear Sir/Madam,

Re: Assistance for Research:

Greetings and best wishes from Uganda Martyrs University.

This is to introduce to you NAPOKO JOSEPH PAUL who is a student of Uganda Martyrs University. As part of the requirements for the award of the Degree of Bachelor of Business Administration and Management of the University, the student is required to submit a dissertation which involves a field research on a selected case study such as a firm, governmental or non governmental organization, financial or other institutions.

The purpose of this letter is to request you permit and facilitate the student in this survey. Your support will be greatly appreciated.

Thank you in advance.

Yours Sincerely,

Moses Kibrai
Dean

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