

FINANCIAL RISK MANAGEMENT AND FINANCIAL PERFORMANCE AMONG REGISTERED INSURANCE COMPANIES, KENYA

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ABSTRACT

Insurance Industry Performance data by the Association of Kenya Insurers (2017) and the Insurance Regulatory Authority (2018) show that the insurance industry performance measures of Insurance penetration, return on equity and Return on Assets have been on the decline. Empirical studies show that there is a significant relationship between financial performance and financial risk management. This has been shown by the effect of single indicators (credit risk, market risk, liquidity risk and operational risk) and financial risk collectively. This paper gives a background on financial risk management and financial performance

and by reviewing other literature, it provides a theoretical and empirical review on the relationship between financial risk management and financial performance. The paper concludes that financial risk management is a key factor in the financial performance of a firm. The paper also provides a platform to fill the research gaps identified and generate an understanding as to if financial risk management has an effect on financial performance among registered insurance companies.

Key Words: *financial risk, credit risk, liquidity risk, market risk, financial performance, firm size*

INTRODUCTION

According to Gupta (2011) every enterprise is subject to several types of risks and the focus varies across organizations. Risk has been defined, classified and interpreted from various perspectives. The description of risk among practitioners ranges from deviations in the value of financial variable(s) to various types of strategic variables. Risk has no universal definition and one way to express it as the variability of outcomes.

Gupta (2011) also notes that Risk refers to the possibility of deviation from the standard path. These deviations reduce the value and imply unhappy situations. Classification of risk as credit, market and operational is a widely accepted methodology. Risk management culture is concerned with having knowledge of the risk exposure, acceptance or transfer of the risk exposure and “embeddedness” of risk management in the company as well as recognizing the change of risk management from an individualistic narrow silo type to portfolio type or an integrated management practice. Mishra et al. (2019) held that risk management is an important activity for organizations that are striving to provide value for their stakeholders in the face of real-world uncertainties. Efficient risk management could potentially present value-creating opportunities that may not have been identified otherwise. Bogodistov & Wohlgemuth (2017) argued that the risk management processes involve the identification, assessment, and management of threatening events as well as the underlying internal communication, decision-making, and monitoring processes that make dealing with those events possible.

Insurance Industry

According to the CII (2018) The principle of insurance and risk management is simply to protect and safeguard the insured from the effect of financial loss due to death or injury (life assurance) or other damage or loss (general insurance) .This can be done by the insured(an individual or a company) insuring with another party against certain situations–using some form of ‘policy’, or in the case of companies –by managing the circumstances so that the risk of damage or loss is reduced. According to the Insurance Regulatory Authority (2018) the mandate of IRA as per the Insurance (Amendment) Act 2006 is to regulate, supervise and promote the development of the insurance industry in Kenya.

Financial Risk Management

According to Mishra et al. (2019) Financial risks are dealt with by modifying business exposure such that the risk was minimized or avoided or through a transfer of the risk, or with hedges against risk exposure. The heightened awareness of the operational and strategic risks in recent years has demonstrated the increasing complexity of managing risks. These risks have the potential to add tremendous value to the organization when appropriately managed, while failure to manage them properly can vastly damage or even the cause demise of the organization. Woods & Dowd (2011) noted that the key aim of financial risk management is to assist management in controlling risks that may affect the achievement of organizational objectives. There is no single ideal risk management package, but risks will be managed most effectively if sound judgment and common sense are combined with the use of a judicious mix of qualitative and quantitative controls.

Akotey & Abor (2013) argued that liquidity Risk is a “run” on an insurance firm resulting from a funding crisis due to the making of large unexpected claims, loss of confidence, write-down of assets or a legal crisis. Such unexpected massive policy withdrawals or cluster claims make the liabilities of insurers much more liquid. However, their assets are less liquid due to the long-term investment horizon of most insurers, especially life assurance firms. Lack of proper judgment in the management of liquidity risk can render an otherwise solvent insurer insolvent. According to Arif & Anees (2012) Liquidity risk management is an essential component of the overall risk management framework of the financial services industry, concerning all financial institutions.

Woods & Dowd (2011) noted that credit risk entails financial risks associated with the possibility of default by a counter-party. Credit risks typically arise because customers fail to pay for goods supplied on credit. Credit risk exposure increases substantially when a firm depends heavily upon a small number of large customers who have been granted access to a significant amount of credit. The significance of credit risk varies between sectors, and is high in the area of financial services, where short- and long-term lending are fundamental to the business. A firm can also be exposed to the credit risks of other firms with which it is heavily connected. For example, a firm may suffer losses if a key supplier or partner in a joint venture has difficulty accessing credit to continue trading. According to Abdullah, Shahimi & Ghafar (2011) Operational risk is the risk of loss resulting from inadequate or failed internal

processes, people, and systems or from external events. This definition includes legal risk, but does not include reputational risk or the risk resulting from strategic decisions. Some operational risks result in increases in the institution's operating cost or decreases in its revenue. Other operational risks interact with credit and market risks. According to Woods & Dowd (2011) market risks are the financial risks that arise because of possible losses due to changes in future market prices or rates. The price changes will often relate to interest or foreign exchange rate movements, but also include the price of basic commodities that are vital to the business.

Firm Size

According to Ahmed, Ahmed, and Ahmed (2010) The size of the firm is another factor that determines an insurance company's financial performance. The size of the firm affects its financial performance in many ways. Large firms can exploit economies of scale and scope and thus being more efficient compared to small firms. Size can be determined by net premium which is the premium earned by an insurance company after deducting the reinsurance ceded. The premium base of insurers dictates the quantum of policy liabilities to be borne by them. Golshan & Rasid (2012) argued that as a firm expand in size, risks facing it also increases. However, with adequate resources at its disposal it is able to dedicate greater resources to risk management.

Financial Performance

According to Samitas & Papadogonas (2009) Financial performance is a measure of an organization's earnings, profits, appreciations in value as evidenced by the rise in the entity's share price. In insurance, performance is normally expressed in net premiums earned, profitability from underwriting activities, annual turnover, returns on investment and return on equity. These measures can be classified as profit performance measures and investment performance measures. Profit performance includes the profits measured in monetary terms. Simply, it is the difference between the revenues and expenses. These two factors, revenue and expenditure are in turn influenced by firm-specific characteristics, industry features and macroeconomic variables. Investment performance can take two different forms. One the return on assets employed in the business other than cash, and two, the return on the investment operations of the surplus of cash at various levels earned on operations. According to Burca & Bartrinca (2014) Profitability, defined as proxy of financial performance, is one of the main objectives of insurance companies' management.

Financial Risk Management and Financial Performance

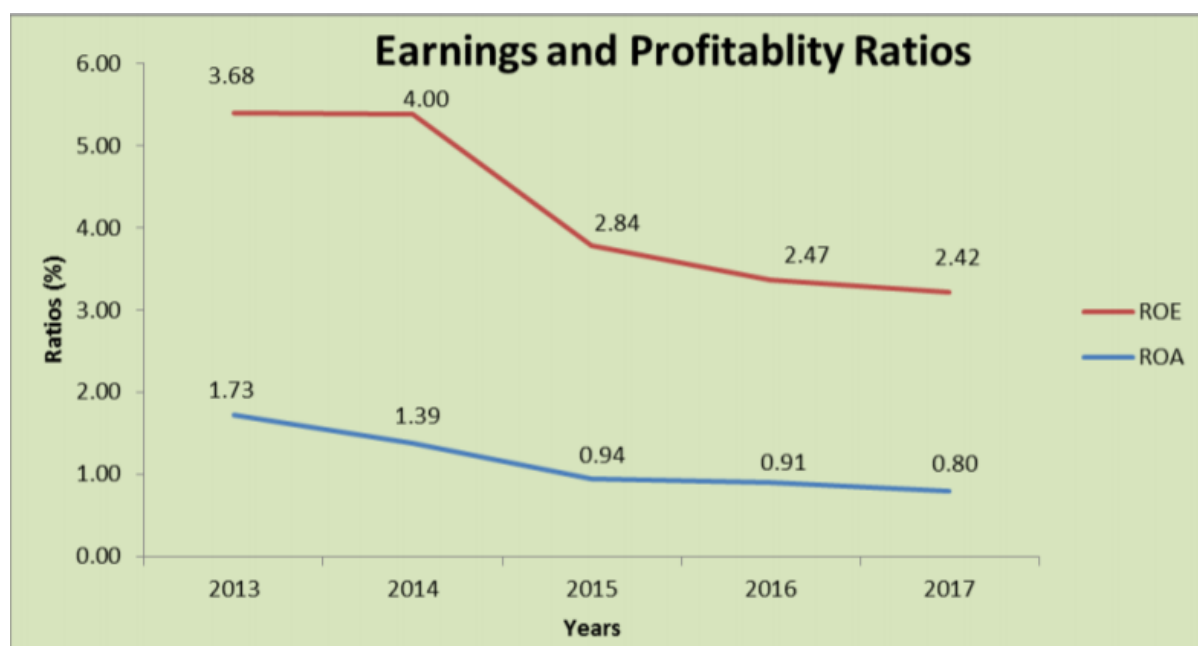
Woods & Dowd (2011) indicated that Risk management is concerned with understanding and managing the risks that an organization faces in its attempt to achieve its objectives. These risks will often represent threats to the organization – such as the risk of heavy losses or even bankruptcy. Risk management has traditionally associated itself with managing the risks of events that would damage the organization. Financial risks create the possibility of losses arising from the failure to achieve a financial objective. Ernst & Young. (2012) identified that the level of risk investment can influence on the financial performance of an organization.

The study identified that financial institutions in the top 20 percent of risk maturity, where maturity was defined by the number of risk management practices applied, generate three times the level of Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA) as those in the bottom 20 percent.

STATEMENT OF THE PROBLEM

Insurance Industry Performance data by the AKI (2017) and the IRA (2018) show that the insurance industry performance measures of Insurance penetration, ROA and ROE have been on the decline.

Figure 1: Industry Trend of Return on Assets (ROA) and Return on Equity (ROE)



Source: (IRA, 2018)

The AKI (2017) carried out a SWOT Analysis of the industry with which they used to derive strategies to attain their targets. The study noted 21 weaknesses that would need to be addressed, among them, low profitability. According to Burca & Bartrinca (2014) profit is an essential prerequisite for an increasing competitiveness of a company that operates in a globalized market. In addition, profit attracts investors and improves the level of solvency, and thus, strengthens consumers' confidence. The financial analysis of a company is an important tool used by actuaries in the process of decision-making on underwriting and investment activities of the insurance company. The financial performance of insurance companies is also relevant within the macroeconomic context since the insurance industry is one of the financial system' components, fostering economic growth and stability.

THEORETICAL REVIEW

There exists a number of theories that explain the relationship between risk and return (financial performance). This paper will review the Capital Asset Pricing Model, Arbitrage Pricing Theory, Agency Theory and the New Institutional Economics Theory.

Capital Asset Pricing Model (CAPM)

The Capital Asset Pricing Model (CAPM), which is now a centerpiece of modern financial economics, was developed by Sharpe (1964) and later modified by Lintner (1965); Mossin (1966). According to Agarwal (2018) this model gives us a precise prediction of the relationship that researcher should observe between the risk of an asset and its expected return. This relationship serves two vital functions. Firstly, it provides a benchmark rate of return for evaluating possible investments. Secondly, the model helps us to make an educated guess as to the expected return on assets that have not yet been traded in the marketplace. The CAPM is therefore, a set of predictions concerning equilibrium between the expected returns on risky assets. It is the relationship between expected return and the risk that is consistent with investors' behavior. A study by Black, Jensen & Scholes (1972) found a positive relationship between returns and beta, in support of the CAPM. The model will be important to this paper as it provides a relationship between risk and return.

Arbitrage Pricing Theory

According to Fabozzi and Drake (2009) the APT model postulates that an asset's expected return is influenced by a variety of risk factors, as opposed to just market risk of the CAPM. The APT assumes that an asset's return is dependent on various macroeconomic, market and security-specific factors. Iqbal and Haider (2005) noted that risk factors in the APT arise from changes in some fundamental economic and financial variables such as interest rates, inflation, real business activity, exchange rate among other variables. The relationship between interest rate and exchange rate and stock returns indicates several issues that may serve as intermediaries or transmission mechanism through which the effect may be observed. Fabozzi and Drake (2009) also argued that the APT model asserts that return on an asset is linearly related to many factors. While CAPM is a one-factor model focusing on market risk as a single factor that influences expected return of a security, the APT picks from this criticism and identifies certain factors such as interest rate, inflation rate, money supply, economic growth, risk premium, and so on that may influence expected returns. The APT theory will be important to this paper as it postulates that an asset's expected return is influenced by a variety of risk factors. This will be key financial risk is a function of credit risk, liquidity risk, market risk and operational risk.

Agency Theory

According to Bendickson et al (2016) The lens offered by agency theory typically hinges around either the principal-agent problem (principal agent research) or governance mechanisms (positivist research). In essence, agency theory stems from an economic view of risk sharing (Eisenhardt, 1989), which occurs between two parties, principals and agents, yet each of the two parties may possess different approaches to solve the problem (Jensen & Meckling, 1976). According to Barnard (1938) the principal's appetite for risk sharing is of concern because the principal has bestowed certain responsibilities unto the agent to achieve like-minded goals. This cooperative behavior is expected to yield the outcomes specified by the principal. However, at the very heart of the agency problem lies the concern of self-

interest behavior that may encourage an overzealous agent to not act in the best interest of the principal (Burnham, 1941). Smith and Stulz (1985) noted that in the field of risk management agency issues have been shown to influence managerial attitudes toward risk taking and hedging.

New Institutional Economics Theory

According to Williamson (1998) the theory predicts that risk management practices may be determined by institutions or accepted practice within a market or industry. The theory links security with specific assets purchase, which implies that risk management can be important in contracts which bind two sides without allowing diversification, such as large financing contract or close cooperation within a supply chain (Akonga, 2014). According to Smith and Watts (1992) regulation is a key determinant of a firm's corporate financial policy. Therefore, if regulated firms face tighter scrutiny and face lower contracting costs, then they are less likely to use derivatives to hedge firm risk. Froot and Stein (2003) showed that if external sources of funds are more costly to a firm than internally generated funds, then the firm could benefit from using derivatives. In particular, firms can hedge cash flows to avoid a shortfall in funds that may require a costly visit to the capital markets and at the same time derivatives are positively related to measures of the firm's investment opportunity set proxies.

EMPIRICAL LITERATURE

Çekrezi (2015) examined the Determinants of financial performance of the insurance companies: A case of Albania. The study was based on data collected from 5 insurance companies. Data was collected from the annual reports published online from the insurers' and from the annual reports delivered to the State Office of Tax during the six-year period 2008-2013. The study used multiple regression analysis to test ROA as dependent variable against the mentioned independent variables. The study concluded that Risk has a negative and significant relation to ROA. The study recommended that Firm's risk, as expected reduces performance and insurance must be very careful on the risk they take. The study was only limited to five factors that affect the financial performance of five companies in Albanian insurance market and further recommended that more research should be done to determine other factors that may affect financial performance.

Abdullah (2011) examined Operational risk in Islamic banks: examination of issues. Descriptive, analytical, and comparative analyses are used to discuss the issues of operational risk in Islamic bank through the implications associated with the Islamic banks' operational risk as well as the implications on risk measurement, risk management, and capital adequacy. The study concluded the several issues around the risk still need to be clarified and addressed further. The fact that there exist a variety and unique nature of financing and investment activities of Islamic banks, each one having its' own risk characteristics affecting both sides of the bank's balance sheet.

Akonga (2014) set to analyze The Effect of Financial Risk Management on The Financial Performance Of Commercial Banks In Kenya. The study was guided by the following indicators: capital risk as measured by total capital to risk weighted assets; liquidity as

measured by current ratio; cash to deposit ratio; NPLs as measured by non-performing loans/total loans. The study analyzed the current financial risk management practices of the 44 commercial banks licensed in Kenya. The researcher adopted descriptive research design and ROA which represents financial performance was averaged for 6 years (2008-2013). The study was based mainly on secondary data which was collected from the annual reports of commercial banks. The researcher in her analysis used multiple regression analysis models which were presented in the form of tables and regression equation. The findings of the study showed that there is a significant relationship between financial performance and financial risk management. The study further recommended that banks should develop strategies to manage risks involved during their operations.

Mwangi (2014) studied The Effect of Risk Management on Financial Performance of Commercial Banks In Kenya. The study was guided by the following indicators: credit risk, insolvency risk, interest sensitivity ratio, capital adequacy, size of bank, operating performance. Census survey methodology of all the licensed 43 commercial banks was used. Secondary Data was collected from Central Bank and banks financial reports and multiple regression analysis used in the data analysis. From the findings the study found that there was a strong positive relationship between risk management and financial performance of commercial banks in Kenya. The study also found that there was a negative relationship between credit risk, insolvency risk, interest rate sensitivity and financial performance of commercial banks. The study further revealed that there was a positive relationship between capital adequacy, size of the banks, operational efficiency and financial performance of commercial banks. The study recommended that there is need for the commercial banks to effectively manage their risk as it was found that risk management positively influence financial performance of commercial banks. The study further recommended that there is need for the management of commercial banks to constantly check their banks' exposure to credit risk, insolvency risk, and interest rate sensitivity. There is need for the commercial banks to enhance their capital adequacy and operational efficiency with respect to their size.

Apanga, Appiah & Arthur (2015) sought to investigate Credit risk management of Ghanaian listed banks. The study was guided by the following research questions: RQ1: what are the credit risk management practices of listed Banks in Ghana?; RQ2: Are these credit risk management practices in line with recommendations of Basel II (1999)? The study examines credit risk management practices from four listed banks in Ghana as at 2007 and employed multiple case studies as a strategy to achieve our objective. The study concluded that Overall, the banks' practices were in line with the required principles except in the case of the role of the boards of directors in the development of credit risk policies and strategies and further discovered that the banks' credit risk management practices are in line with sound practices. Further the study recommended that the banks should also consider intensifying research into the use of credit derivatives. This has become essential due to the increasing product complexity provided by new international universal banks entering the Ghanaian banking industry.

Arif & Anees (2012) set out to study Liquidity risk and performance of banking system in Pakistan. The study was guided by the following hypotheses: Increase in deposits boosts up

the earnings of the bank; Increase in cash reserves decreases the earnings of the bank; Increase in the liquidity gap causes a reduction in the bank's earnings; High provisioning for NPLs will cause a decrease in the bank's earnings. Data was retrieved from the balance sheets, income statements and notes of 22 Pakistani banks during 2004-2009. Multiple regressions are applied to assess the impact of liquidity risk on banks' profitability. The results of multiple regressions showed that liquidity risk affects bank profitability significantly, with liquidity gap and non-performing as the two factors exacerbating the liquidity risk. They have a negative relationship with profitability.

Tabari, Ahmadi & Emami (2013) investigated the effect of Liquidity Risk on the Performance of Commercial Banks. The specific independent variables used for the study were Bank's Size, Bank's Size Square, Bank's Capital, Credit Risk, Gross Domestic Product, Inflation. The performance of fifteen Iranian banks is examined during an eight-year period from 2003 to 2010 using of panel data and the study used multivariate regression to analyze the relationship between the variables. The study found that bank's size, bank's capital, gross domestic product and inflation cause to increase in the profitability of bank, while credit risk and liquidity risk will cause to decrease in the bank's profitability.

Muriithi, Muturi & Waweru (2016) studied The Effect of Market Risk on Financial Performance of Commercial Banks in Kenya. The study covered the period between year 2005 and 2014. Market risk was measured by degree of financial leverage, interest rate risk and foreign exchange exposure while financial performance was measured by return on equity. The study used the balance sheets components and financial ratios for 43 registered commercial banks in Kenya. Panel data techniques of random effects, fixed effects estimation and generalized method of moments (GMM) were used to purge time-invariant unobserved firm specific effects and to mitigate potential endogeneity problems. The study concluded that financial leverage, interest rate and foreign exchange exposure have negative and significant relationship with bank profitability. The study further recommended that commercial banks especially locally owned are required to consider finding ways of mitigating the market risks by use of financial instruments such as financial derivatives and be active in derivatives markets. These may reduce their interest rate risk and foreign currency risk exposure. The commercial banks are also required to monitor the financial leverage so as to reduce the financial risk.

FINDINGS

Empirical studies identified in this paper show that that there is a significant relationship between financial performance and financial risk management. This has been shown the effect of single indicators (credit risk, market risk, liquidity risk and operational risk) and financial risk collectively. Tabari, Ahmadi & Emami (2013) and Arif & Anees (2012) showed liquidity risk will cause to decrease in profitability. Apanga, Appiah & Arthur (2015) and Tabari, Ahmadi & Emami (2013) found that credit risk will significantly affect profitability. Muriithi, Muturi & Waweru (2016) concluded that market risk factors have negative and significant relationship with profitability. Akona (2014) found that there is a significant relationship between financial performance and financial risk management.

Çekrezi (2015) concluded that a firm's risk reduces performance and insurance must be very careful on the risk they take. This leads us to the conclusion that each of the indicators of financial risk and collectively have a significant negative effect on an institution's profitability.

CONCLUSION

Empirical studies identified in the paper show that financial risk management is a key factor in the financial performance of a firm. Woods & Dowd (2011) noted that the key aim of financial risk management is to assist management in controlling risks that may affect the achievement of organizational objectives. However, in as much as a number of studies have been conducted on the banking industry, few of this nature have been conducted in the insurance industry and less so in Kenya. With the current trend shown of decreasing profitability in insurance companies towards finding solutions towards this problem. In this regard, this paper provides a platform to fill this research gap and generate an understanding as to if financial risk management has an effect on financial performance among registered insurance companies.

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