



## Impact of Risk Management on Profitability of Commercial Banks: A Case of Nyamagana District, Mwanza-Tanzania

By

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### Abstract

*The contribution of financial institutions is crucial to the expansion of every nation's economy. The ability of financial organizations to manage several kinds of risks, such as trading, credit, and liquidity hazards, among others, is essential to their existence. This study's primary goal was to investigate how risk management affected the Nyamagana district's commercial banks' profitability. The particular goals of the study are (i) to investigate how credit risk management affects commercial banks' profitability and (ii) to investigate how liquidity risk management affects commercial banks' profitability. The study employed a cross-sectional research design and a quantitative approach to collect and analyze data. Twenty percent of the 18 commercial bank employees who were the study's target group were chosen as a sample. Four banks were chosen using the criterion sampling technique. Data was taken from annual reports of selected banks from 2019 to 2023. The results were presented using both descriptive and inferential statistics. The results of the study demonstrate that both operation risk and credit risk have a detrimental effect on commercial banks' profitability. The expansion of a bank is positively impacted by both capital sufficiency and deposit growth. Commercial banks are more profitable when they have adequate capital and customer deposits. According to the survey, banks should keep enhancing their risk management procedures in order to continue functioning efficiently.*

## INTRODUCTION

Due in large part to the industry's intrinsic complexity and the profound effects of banking crises on economies, risk management in the banking sector has been at the forefront of international financial discourse. Commercial banks are vital to the global economy because they provide essential financial services and encourage economic growth (Sharma, Gupta, and Jangir 2024). Tursoy (2018) asserts that financial institutions' ability to control a variety of risks, including as trading, liquidity, and credit risks, is essential to their continued existence. The capacity to control these risks is particularly important in developing nations like Tanzania, whose financial ecosystems frequently encounter particular difficulties.

The banking industry is essential to promoting socioeconomic development, financial inclusion, and economic prosperity. The banking industry continues to be a vital pillar in bolstering Tanzania's ambitions as the nation makes great strides toward becoming a middle-income nation. According to Sathyamoorthi et al. (2020), banks are primarily

responsible for transferring capital from families to enterprises with productive uses in developing economies with low levels of financial expertise.

Therefore, it is essential that this position be effective and maximized in order to guarantee economic progress. Therefore, a significant portion of this function involves evaluating the economic risks of prospective projects and enterprises and setting their prices adequately to guarantee that the projects are properly funded and structured while keeping the financing bank's investments profitable. But according to Gitonga (2020), risk management is a crucial component of any firm and is mostly caused by newly emerging threats. Additionally, risk management has grown in importance, and different regulators are requesting risk management frameworks. According to Kuwara and Sunusi (2014), credit management is therefore focused with risk management. Risks and rewards that must be objectively managed through rigorous and cautious risk management; otherwise, there may be legal action, financial loss, or damage to the bank's reputation. According to Qin and Patory (2012), commercial banks' profitability is based on their capacity to



hold onto capital, absorb loan losses, sustain asset growth in the future, and give investors a return. Interest income from lending activities, less interest paid on debt and deposits, is the bank's main source of revenue. According to Ikponmwoosa (2020), the banking industry entails a significant degree of risk and unpredictability, which may have an effect on the company's profitability.

Awoke (2014) found that there was a strong correlation between risk management and profitability in North American, European, and Australian banks. But according to a different study by Gitau *et al.* (2017), there is a negative correlation between risk management and profitability. In addition, Gathaiya (2017) examined the problems that impacted the banks that failed and concluded that risk or inadequate management was to blame. Furthermore, risk assessment and approval, as well as risk supervision and monitoring, have a detrimental impact on banks' earning capacity and liquidity. However, Tanzanian financial institutions' implementation of credit risk management was deemed inadequate by Makono and Mbogo (2023). It was found that although commercial banks have tools, policies, and processes for controlling credit risk, these are not always adhered to.

### Statement of the problem

It has been demonstrated that risk management is a disadvantage of the financial crisis involving banks. It is the most important risk that banks have to deal with. According to research, risk management is essential to commercial banks' efficient operation. Therefore, in order to reduce the possibility of failures linked to poor management of the underlying indicators, managers working in the best interests of the shareholders should control the risk items. The profitability of Tanzania's banking sector has been dropping over time, despite the institutions' tremendous efforts to control risks. In particular, the high percentage of non-performing loans brought on by credit risk has made it difficult for the banks to maintain a high level of capital adequacy.

Additionally, banks' liquidity risk management procedures have been insufficient, resulting in a high level of liquidity risk and a fall in the bank's profitability. According to Temba *et al.* (2024) and Makono and Mbogo (2023), risk assessment has a detrimental impact on banks' earning capacity and liquidity, and credit risk management was poorly executed in Tanzanian financial institutions. Bankers also showed a low level of awareness regarding the principles of credit risk management. In order to determine the underlying causes of the issues and suggest solutions to reduce these risks, it is vital to look into how risk management affects the profitability of Tanzanian commercial banks, with an emphasis on credit risk management, operational risk management, and liquidity risk management.

### General Objectives

The main objective of this study was to examine the impact of risk management on profitability of the commercial banks in Nyamagana district.

### Specific Objectives

- i. To examine the effects of credit risk management on profitability of the commercial banks.
- ii. To examine the effects of Liquidity risk management on profitability of the commercial banks.

### Research Questions

- i. What are the effects of credit risk management on profitability of the commercial banks?
- ii. What are effects of Liquidity risk management on profitability of the commercial banks?

### Literature Review Theoretical Part

Freeman (1984) developed the stockholder hypothesis as a management tool, and it has since developed a strong capacity to explain company performance. The primary factor influencing business policy, according to stakeholder theory, is the balance of stakeholder interests. Stakeholder theory thus offers a fresh perspective on potential justifications for risk management. It hasn't been put to the test yet, though. Stakeholder theory is predicated on the notion that businesses function within an ecosystem of diverse stakeholders, each of whom contributes to the company's sustainability and ability to create value for all stakeholder groups (Gutterman 2023). In order to ascertain whether the actions have a value addition or retention effect on the organization, the theory makes sure that actual risk management decisions are understood. Its capacity to recognize and rank the requirements and interests of many stakeholder groups, such as shareholders, staff, clients, suppliers, and the general public, is one of its advantages. In addition to helping managers make well-informed decisions that consider the requirements and expectations of all stakeholders, this theory offers a thorough method for comprehending the intricate relationships that exist between an organization and its stakeholders. Businesses are encouraged by stakeholder theory to take into account a wider variety of interests and effects when making decisions.

As a result, corporate plans become more comprehensive and well-rounded. The Stakeholders Theory has many drawbacks in spite of its advantages. The lack of a defined framework for ranking the interests of various stakeholders is one of the main objections leveled about stakeholder theory. In reality, juggling competing stakeholder interests can be difficult, which could cause decision-making paralysis. For instance, it may be challenging to pinpoint a single set of demands or expectations since different stakeholders may have competing interests or objectives. Furthermore, the theory makes the potentially unfounded assumption that all stakeholders are equal and have equal sway over the company. Since the interrelationships of the credit management team are necessary for both short-term and long-term profitability, the theory is suitable for the study. Estimation, which will eventually raise an organization's profitability levels and lower its risk. Furthermore, the theory highlights how crucial it is for organizational decision-making processes to take into account the requirements and interests of several stakeholders,

not only shareholders.

### Empirical Review

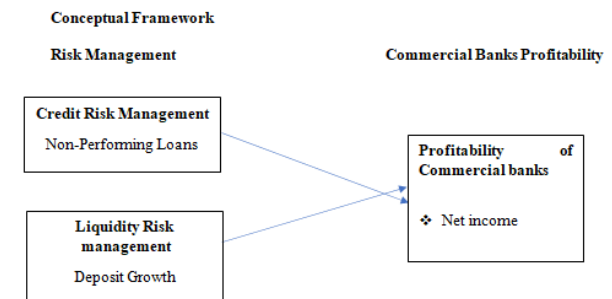
Using information gathered from the Bank of Sierra Leone (BSL) on pertinent Financial Soundness Indicators such as ROA, Bank Liquidity, NPL, and Credit data for the years 2008– 2018, Jackson et al. (2022) evaluated the relationship between credit risks and the performance of commercial banks in Sierra Leone. Credit risk and banking performance in Sierra Leone are negatively correlated, according to the study's quantitative research approach. Tuladhar (2017) looked into how Nepalese commercial banks' profitability was affected by credit risk management. Pooled regression analysis and panel data analysis were used to gather and examine data from 28 commercial banks between 2011 and 2015. The results show that credit risk management significantly affects Nepalese businesses' profitability. The findings indicate that bank size, coverage ratio, and capital adequacy ratio all improve bank performance. The goal of Saeed and Zahid (2016) was to examine how credit risk affected the profitability of five major commercial banks in the United Kingdom. ROA and ROE, two dependent variables, were taken into consideration for calculating profitability. It was discovered that the profitability of the banks was positively correlated with credit risk indicators. This indicates that UK banks continue to take credit risks and profit from interest rates, fees, and other incentives despite the severe consequences of the 2008 financial crisis. The findings also show that there was a positive correlation between bank expansion, leverage, and size.

Ghana's rural and community banks were chosen for the study using the purposive sampling technique. Annual reports from Ghanaian rural and community banks covering the years 2014– 2018 were used in the study. The results indicate a negative correlation between the financial performance metrics and the two credit risk indicators. The study comes to the conclusion that credit risk is a factor that affects the financial performance of rural and community banks, and that credit risk is rising gradually and could do so in the future. The impact of credit management on the financial performance of Nigerian deposit money banks was the main subject of Philip and Abisola's 2019 study. Its foundation is secondary data gleaned from online audited financial statements of the companies.

Because their proxies had a p-value below the 5% benchmark set by SPSS statistical software, the analysis's findings indicate a substantial association between credit management and deposit money institutions' profitability. The impact of credit risk management on Tanzanian commercial banks' profitability was also ascertained by Nshala (2017). A sample of 19 commercial banks' published financial statements spanning 11 years, from 2005 to 2015, provided secondary panel data for the analysis. The findings show a substantial inverse link between ROE and the NPL/TL ratio. Additionally, it was shown that CAR had a strongly positive correlation with ROA but a negligible correlation with ROE. The primary goal of a study conducted by Khalid et al. (2019) was to ascertain how

liquidity risk management affected the financial performance of commercial banks in developing nations like Bangladesh. The target population for this quantitative study was the commercial banks that were listed on the Dhaka Stock Market between 2010 and 2017. The results of the study showed a substantial inverse link between commercial bank performance and liquidity risk management. When it comes to various dependent variables, liquidity risk performs similarly. The purpose of the study by Malik et al. (2016) was to look at the connection between profitability and liquidity in Pakistani private sector banks. Twenty-two private sector banks that were registered with the State Bank of Pakistan were the subject of the study between 2009-2013. The empirical findings showed a statistically significant correlation between return on assets and bank liquidity metrics. Furthermore, El-Moslemany et al. (2021) examine the relationship between bank profitability (ROA, ROE, and NIM) and liquidity risk (liquidity asset ratio, or LIQR, cash ratio, or CASR, current ratio, or CURR, and basic defense ratio, or BDR) for Egypt's banking industry, which includes both public and private banks. The findings indicated a strong correlation between bank profitability and liquidity risk in the Egyptian banking industry from 2013 to 2019.

But depending on the metric used to gauge banks' profitability and liquidity, the link could be either positive or negative. According to Ajayi and Lawal (2021), profitability and liquidity management are crucial for the expansion and continued existence of companies, especially financial institutions. The purpose of the study was to use secondary data to investigate the connection between bank performance and liquidity management. Information gathered over a ten-year period (2009-2018) from the published annual reports of five (5) selected Deposit Money Banks in Nigeria. Return on assets served as a stand-in for profitability, while the loan to deposit ratio, loan to assets ratio, and liquid ratio are the proxies for liquidity management. According to the study's findings, Nigerian banks' profitability and liquidity management are significantly and favorably correlated. It is advised that banks always make an attempt to efficiently manage their credit by closely following rules on granting credits.



Source: Researcher (2024)

### Research Methodology

Quantitative research methodology was employed in this investigation. Quantitative research made it possible to examine links, patterns, and trends within datasets by utilizing

statistical techniques and approaches. Cross-sectional and longitudinal research designs were used in this study. Participants in the cross-sectional study are chosen in accordance with the inclusion and exclusion criteria established for the research. Additionally, this design makes it possible to compare different banks with different risk management policies and profitability levels, offering insights into possible relationships between risk management tactics and financial results. The Mwanza region's Nyamagana district served as the study's site. There are eight districts in Tanzania's Mwanza Region, including Nyamagana District. In the Nyamagana district, 18 commercial banks were among the study's target population. Consequently, 20% of the total population was used to calculate the study's sample size. This means that  $20\% \times 18 = 3.6 \approx 4$ . Consequently, four commercial banks made up the sample size. Four commercial banks were chosen by the researcher using simple random selection and criterion sampling. Four chosen commercial banks provided data for the documentary evaluation. To obtain a thorough grasp of a study problem, data analysis entailed applying quantitative data analysis. The results were expressed using descriptive and inferential analysis. In order to analyze and interpret the results, this study employed a variety of statistical patterns, including graphs, figures, percentages, frequencies, and descriptive statistics (mean and standard deviation).

With the use of SPSS 26, a multiple regression analysis model was employed to examine the data and show the results, which included inferential analysis (correlation and regression) to ascertain the cause-and-effect of independent and dependent variables.

### Study findings and interpretation

Inferential statistics (correlation and regression coefficients) are used to discuss the causes and effects among the variables after descriptive statistics have been utilized to demonstrate each bank's profitability performance versus the risk involved.

#### Descriptive Statistics

	Minimum	Maximum	Mean	Std. Deviation
CREDIT RISK	2.7425	7.875	4.802	1.9213
CAR	12.96	15.202	14.207	.99547
DEPOSIT GROWTH	6.095	19.905	13.46	5.795
ROA	20.47	23.7472	22.3495	1.3840
Valid N				

Overall credit risk ranges from a minimum of 2.7425 to a maximum of 7.875. A considerable degree of credit risk is indicated by the mean value of 4.802 for all commercial banks. Some banks are subject to significantly higher credit risk than others, as indicated by the standard deviation of 1.9213, which indicates significant heterogeneity in credit risk. As seen in the above table, liquidity was assessed using the Capital Adequacy Ratio (CAR) and Deposit Growth. With a mean of

14.207%, the CAR ranges from a low of 12.96% to a maximum of 15.202%. Commercial banks often maintain a steady and sufficient capital buffer, as seen by the comparatively low standard deviation of 0.99547, which shows that CAR values are very close to the mean. Overall deposit growth ranges from a low of 6.095% to a maximum of 19.905%. A moderate increase in deposits across all commercial banks is indicated by the mean value of 13.46%. Significant variety is suggested by the standard deviation of 5.795, which shows that some banks expand at significantly faster rates than others. Overall ROA ranges from a minimum of 20.47% to a maximum of 23.7472%. Strong profitability is indicated by the average of 22.3495% for all commercial banks. The majority of banks have rather stable levels of profitability, as indicated by the standard deviation of 1.3840, which indicates moderate fluctuation.

### Correlation Analysis

		CREDIT RISK	CAR	DEPOSIT GROWTH	ROA
CREDIT RISK	Pearson Correlation	1	-.095	-.575	-.585
	Sig. (2-tailed)		.879	.310	.301
	N	5	5	5	5
CAR	Pearson Correlation	-.095	1	-.632	-.560
	Sig. (2-tailed)	.879		.253	.326
	N	5	5	5	5
DEPOSIT GROWTH	Pearson Correlation	-.575	-.632	1	.992**
	Sig. (2-tailed)	.310	.253		.001
	N	5	5	5	5
ROA	Pearson Correlation	-.585	-.560	.992**	1
	Sig. (2-tailed)	.301	.326	.001	
	N	5	5	5	5

\*\* . Correlation is significant at the 0.01 level (2-tailed).

According to the following table result, there is a very modest negative association ( $r = -0.095$ ) between CAR and credit risk. This implies that CAR somewhat declines as credit risk rises, albeit the correlation is really weak. Credit Risk and Deposit Growth have a moderately negative connection ( $r = -0.575$ ). This suggests that lower deposit growth is linked to increased credit risk.

Credit Risk and ROA have a moderately negative connection ( $r = -0.585$ ). This implies that ROA tends to decline as credit risk rises, suggesting that increased credit risk may have a

detrimental effect on profitability. CAR and Deposit Growth have a moderately negative connection ( $r = -0.632$ ). This suggests that lower Deposit Growth is linked to higher CAR. CAR and ROA have a moderately negative connection ( $r = -0.560$ ). This implies that, while the correlation is weak, higher CAR may be linked to lower profitability. ROA and Deposit Growth have a very significant positive association ( $r = 0.992$ ). This suggests that there is a strong correlation between increased profitability and larger deposit growth. Although these correlations are not statistically significant, lower profitability and slower deposit growth are often linked to increased credit risk. Again, these associations are not statistically significant, but higher CAR is generally linked to lower profitability and deposit growth. Banks with larger deposit growth are often more profitable, according to the very strong and highly significant positive link with ROA. Deposit growth and ROA have a substantial and positive correlation, indicating that profitability is greatly impacted by effective asset use to draw deposits.

### Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.998 <sup>a</sup>	.996	.985	.169070982490419

a. Predictors: (Constant), DEPOSIT GROWTH, CREDIT RISK, CAR

According to the above table result,  $R=0.998$  shows that the dependent variable (ROA) and the predictors (Overall Credit Risk, Overall CAR, and Overall Deposit Growth) have a very significant positive association. The model is particularly successful in describing the variation in commercial banks' profitability (ROA), as evidenced by the extremely high R Square and Adjusted R Square values. This implies that key factors influencing profitability are risk management techniques, as indicated by Credit Risk, CAR, and Deposit Growth.

### Regression Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error			
1	(Constant)	14.130	2.941		4.805	.013
	CREDIT RISK	-.085	.078	.118	1.092	.002
	CAR	.281	.159	.202	1.768	.028
	DEPOSIT GROWTH	.284	.033	1.188	8.539	.034

a. Dependent Variable: ROA

The unstandardized coefficient for credit risk is  $-.085$ , which means that, when all other factors are held constant, the ROA

falls by  $.085$  units for every unit rise in credit risk. The correlation between Credit Risk and ROA is weakly negative, as indicated by the standardized coefficient (Beta) of  $.118$ . Given the extremely low p-value ( $.002$ ), which suggests that this association is statistically significant, Credit Risk significantly lowers ROA in this model. The ROA rises by  $.281$  units for every unit increase in the Capital Adequacy Ratio, according to the unstandardized coefficient for CAR, which is  $.281$ . A moderately positive relationship is indicated by the standardized coefficient (Beta) of  $.202$ . This association is statistically significant, as indicated by the p-value ( $.028$ ), which suggests that CAR has a favorable impact on ROA. With an unstandardized coefficient of  $.284$ , Deposit Growth appears to have a favorable effect on ROA. A high positive correlation is indicated by the standardized coefficient (Beta) of  $1.188$ . This link is statistically significant, suggesting Deposit Growth significantly improves ROA, as seen by the p-value ( $.034$ ) being below the traditional significance level.

### Discussion of the Findings

The unstandardized coefficient for credit risk is  $-.085$ , which means that, when all other factors are held constant, the ROA falls by  $.085$  units for every unit rise in credit risk. The correlation between Credit Risk and ROA is weakly negative, as indicated by the standardized coefficient (Beta) of  $.118$ . The findings indicate that commercial banks' profitability is negatively impacted by rising credit risk. Profitability and credit risk are negatively correlated, according to numerous research. For instance, a study by Hambolu et al. (2022) shows that worse bank profitability is linked to credit risk, which is commonly gauged by the percentage of non-performing loans to total loans.

This is due to the fact that increased credit risk indicates a greater chance of loan defaults, which results in larger loan loss provisions and less net income. The findings further support Tuladhar's

(2017) assertion that the profitability of banks was substantially impacted by credit risk indicators such as the ratio of non-performing loans and loan loss provisions. Profitability is adversely affected by a growth in non-performing loans since it lowers interest income and increases loan loss provisions. Abiola and Olausi's (2014) study looked at how credit risk affected a few Nigerian banks' profitability and came up with conflicting findings. Some banks were severely impacted, but others were able to stay profitable in spite of high credit risk levels by using strategic lending techniques and efficient risk management. According to the findings, commercial banks' profitability is positively impacted by both capital adequacy and deposit growth, which is a component of liquidity risk. The ability of a bank to withstand losses and preserve financial stability is shown by the Capital Adequacy Ratio (CAR), which compares the capital of the bank to its risk-weighted assets. Investors and depositors view banks with higher capital adequacy ratios as less risky. Funding expenses may decrease as a result of this better perspective. Lower funding costs lower the bank's overall expenses, which increases profitability. A bank with a higher CAR has a higher

capital threshold to support its lending operations. The bank can provide more loans thanks to its expanded lending capacity, which can boost profitability by bringing in more interest revenue. The findings are in line with those of Hambolu et al. (2022), who discovered that banks with adequate capital had lower funding costs and more investor trust, which boosts profitability. Strong capital levels enable banks to withstand shocks and sustain profitability during economic downturns, so contributing to long-term financial performance, according to a different study by Dietrich and Wanzenried (2011). Additionally, a rise in deposits gives banks additional money to lend. Banks can offer more loans when they have more deposits, which can result in more interest revenue. Greater loan volumes might result in improved profitability because interest income from loans usually makes up a sizable amount of a bank's revenue. According to a 2017 study by Tuladhar, increasing deposits lowers the cost of capital and increases liquidity, which boosts financial stability and profitability.

## Conclusion

Credit risk has a detrimental effect on commercial banks' profitability, according to the majority of studies. Increased provisions for loan losses and a higher percentage of non-performing loans are usually the results of higher credit risk, which lowers net income and profitability. The degree of this influence, however, may differ depending on a number of variables, including the bank's risk management procedures, the state of the economy, the legal system, and the bank's capacity to diversify its loan portfolio. The availability of liquidity has a major effect on commercial banks' profitability. Two crucial elements of the liquidity component are the Capital Adequacy Ratio (CAR) and deposit growth. The ability to lend more money to customers, which in turn generates more interest income, is made possible by the availability of cash. Additionally, customer deposit growth is crucial. In addition to lending more money to borrowers, this gives commercial banks extra money to meet other regulatory requirements.

## Recommendations

Banks should keep a careful eye on and control credit risk. Strict credit standards should be put in place, and improving risk assessment instruments can aid in preserving or lowering credit risk. Examine ways to increase ROA even further by increasing revenue streams and streamlining operations, possibly through the introduction of new financial services or products. To enhance resilience against financial shocks, all commercial banks should keep up a robust CAR. Review and modify the capital plan on a regular basis to conform to growth plans and regulatory requirements. Investing in customer acquisition tactics and enhancing customer retention initiatives to maintain the rise of deposits. Increase the variety of deposit items to draw in a wider clientele.

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