European Journal of Business and Social Sciences, Vol. 6, No. 07, **October 2017.** **P.P. 24 - 32**
URL: *http://www.ejbss.com/recent.aspx-/*
ISSN: 2235 -767X

INFLUENCE OF COMPLIANCE RISK MANAGEMENT ON FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN RWANDA: CASE OF BANK OF KIGALI.

SAMUEL MWAURA KIUMBE
Jomo Kenyatta University of Agriculture and Technology,
Kigali, Rwanda.

Dr. PATRICK MULYUNGI (PhD)
Jomo Kenyatta University of Agriculture and Technology,
Kigali, Rwanda.

Dr. KULE WARREN JULIUS (PhD)
Jomo Kenyatta University of Agriculture and Technology,
Kigali, Rwanda.

Ms. JACKLINNE KIBACHIA
Jomo Kenyatta University of Agriculture and Technology,
Kigali, Rwanda.

ABSTRACT

Banking sector in Rwanda has undergone significant transformation and continues to improve with new regulations and guidelines seeking to maintain stability. Banks today operate in an environment marked by growing consolidation, rising customer expectations, increasing regulatory requirements, technological innovation and mounting competition. Compliance risk is thus seen as a major challenge today and is described as "life threatening" in the banking industry. Compliance risk losses have often led to the down fall of many financial institutions. For many organizations, ineffective management of compliance risk has already resulted in unforeseen costs in terms of fines, penalties, corrective labor, and the inability to secure new business hence impacting negatively of profitability. The general objective of this study was to assess the influence of compliance risk management on financial performance of commercial banks in Rwanda. The significance of the study was to reveal the extent to which compliance risk management affects performance of banks in Rwanda, the need for banks to effectively manage their compliance risk to minimize its effect on their operations and how banks could gain competitive advantage through the management of their compliance risk. The target populations was 250 staff based in BK main branch and particularly staff who work in Risk and Compliance, Credit, Legal, and internal audit and purposive sampling will be applied. The study was based in the period of three years between 2013 -2015. The study utilized both primary and secondary sources of data. The primary sources will be obtained from the bank head office branch. The research study adopted a questionnaire as a key instrument for primary data collection. Both descriptive and inferential research methods were used to analyze data collected. From the findings, it is clear that the banking industry in Rwanda is growing a steady rate and consequently the players need to comply with certain regulations in the market. In addition accountability contributes more to financial performance in the commercial banks in Rwanda. Further, control environment as compliance risk management practice influences financial performance in Rwandan commercial banks. The findings indicated that banks' audit control environment has a significant positive relationship with financial performance. In addition, control environment and accountability are significantly positively related; hence, they influence the operations of commercial banks. The study recommends that Commercial banks in Rwanda should maintain and strengthen control environment in order to increase their financial performance that enhances better operations in the financial market. The banks also need to improve their liquidity level through increasing their current assets that can easily be converted into cash. This level of assets should be above the liabilities in order to meet the creditors' demands when there is need. Finally, there is a need to consider interviewing customers of the commercial bank in Rwanda so that their views are also captured instead of bank staff as in this case.

Key words: control environment, accountability, monitoring and evaluation and financial performance.

1.1 Background

The Banking sector has undergone significant transformation and continues to improve with new regulations and guidelines seeking to maintain stability. This has made the sector more efficient, innovative, competitive and profitable. The transformation of the industry has resulted in an emergence of technologically innovative products and services (Anderson, 1999). Banks have employed these innovative products and services in their operations so as to provide customers with easy accessibility. The new capital requirements may lead to an improved buffer for risk absorption in the sector. However, increased competition, growing customer demands, and new regulations are likely to continue to add complexity to business models of banks and information technology environment. These complexities may not be easily unraveled and can lead to the inability to capture or respond rapidly and successfully to emerging external opportunities (Curtis et al., 1992).

Companies around the world have made substantial investments in personnel, processes and technology to help control business risk (Mills, 2008). Historically, these risk investments have focused primarily on financial controls and regulatory compliance. Too many financial institutions took on excessive risk with too little regard for reasonable, realistic long-term performance expectations. The debacle is focusing minds on more robust approaches to risk management, with a new imperative to keep pace with financial innovation, performance incentives, and business goals. Reforms will stretch risk management across the organization and involve systematically linking risk and corporate performance management, leading to an informed view of reward (Parker and Nielsen, 2009).

According to Verrecchia (2001), Companies that keep their proverbial eyes on the ball on improving performance, both financially and operationally will emerge from these trying times better positioned to take advantage of opportunities. However, conducting business as usual is in itself a risky proposition. Compliance-driven approaches to managing risk no longer suffice in an increasingly volatile, interconnected business environment. Approaches to risk management need to provide business leaders and their boards of directors with an integrated view of risk and performance that defines how rapidly emerging events will impact operations, quality, and, ultimately, shareholder value.

Recent research shows that many companies fail to connect risk and performance in the course of basic performance management (Basel, 2008; Carreta & Farina, 2010). External stakeholders are already motivating companies to take a fresh approach to aligning their risk appetites and performance objectives in a smarter, more systematic way. Company directors, credit rating agencies, and institutional investors alike are scrutinizing the risk-reward relationship and formalizing their own linkages between risk and performance, creating new expectations and market demands for businesses.

It should be understood at the start that this is not merely a defensive response to greater uncertainty in the business environment and, for some, to pending regulation (Mills, 2008). According to Tse & Yaansah (1999), banks are recognizing that the same drivers of increased volatility capital mobility, rapid innovation, and the development of new business models also offer opportunities that they must exploit to increase revenue, improve shareholder value, and satisfy evolving customer demands. With an integrated, principled approach to managing risk and business performance, companies can seize with greater confidence the opportunities that an interconnected economy presents.

The process of connecting risk and reward starts at strategy setting. When company leaders understand the greatest sources of value creation and destruction across their organizations, when they assign clear accountability for risk management and performance management, and when they systematically quantify the rewards associated with the risks, they change the decision-making game for their managers (Sobel, & Reding, 2004).

Rwanda ‘s banking sector is composed of eleven commercial banks and five specialized institutions (that include three microfinance banks, one development bank and one co-operative bank). Banking service operations date back in early 1960, originating from the oldest banks of BCR (Currently I&M Bank Rwanda) and Bank of Kigali (BK) respectively (Ecobank, 2013). Recently, most commercial banks have centered their operations on trade finance as opposed to long-term debt financing. This has triggered off to lack of productive investment activity, thus there is urgent need to focus attention on the reform and strengthening of the financial sector. This appeal for introduction of more banks, financial products and capital market.

However, banking sector penetration still remains low, with the ratio of total banking sector assets to GDP standing at 28% in local currency terms, and representing a massive growth opportunity. The Bank of Kigali (BK) continued its dominance as the country ‘s largest bank, with total assets worth USD 774 million at the close of 2015. From a profitability perspective, the Rwandan banking sector ‘s13% return on equity (ROE) places it at the bottom of the profitability rankings of the EAC region. However, on a micro-level, Banque Commerciale du Rwanda (Currently known as I&M bank Rwanda) is the country ‘s most profitable bank. With regard to efficiency, the country ‘s banking sector ranked as least efficient compared to its major EAC peers, with a consolidated cost-to-income ratio (CIR) of 71%. However, on a micro-level, BK is the most efficient bank while Equity Bank ranked at the bottom as the least efficient one. Overall capital adequacy levels remained strong and the sector still ranks as the most capitalized one in the EAC region, with industry total qualifying capital to total risk assets standing at 25%, well above the regulatory threshold of 15% (Ecobank, 2013).

Commercial banks are among the main institutions that play a key role in maintaining good corporate governance in Rwanda. These commercial banks have stringent rules for borrowers including audited financial reports, corporate structure, list of directors, and subjecting borrowers to greater scrutiny (Mwika, 2012). Commercial banks in Rwanda play an important role in the economic development of the country. One way to attain efficiency and effectiveness in the banking sector in Rwanda is through good corporate governance practices. Sound corporate governance practices will also bolster confidence in the capital market and the confidence of the Rwandan society in general, in the way in which business functions (PSF Rwanda, 2009).

Through product service innovation, banks are attempting to achieve a finer degree of control over financial risks. Through adoption of new technology like Electronic Funds Transfer (EFT) and Real Time Gross Settlement System (RTGS), Banks have radically altered the face of the banking environment. New IT products have changed the way banks do business by reducing the banking processes and increasing transparency, on the contrary new technology have weakened the traditional relationship between clients and their banks. This is because the branch network system ensures that one is not restricted to transacting at the branch where the customer opened an account.

The above changes have contributed immensely to the increasing competition in banking industry especially with regard to the number of financial products available in the market that is comprised of an increasingly more sophisticated clientele. Rwandan Banks are therefore expected to develop strategic responses to address the changing competitive environment in which they operate.

Bank of Kigali is a commercial bank in Rwanda and licensed by the National Bank of Rwanda, the national banking regulator. As of December 2013, BK was a medium-sized financial services provider in Rwanda. Its total asset valuation was approximately US$232.3 million (RWF:157.44 billion). At that time, shareholding in the bank was valued at about US$20.3 million (RWF:13.8 billion). The bank focused its lending to businesses in the agricultural sector. It employed 1,477 staff at that time. The bank's stock is owned by Rabo bank and Rwanda Savings Cooperatives. The activities of Bank of Kigali are supervised by a nine-member board of directors.

1.2 Statement of the Problem

Banks today operate in an environment marked by growing consolidation, rising customer expectations, increasing regulatory requirements, technological innovation and mounting competition. Compliance risk is thus seen as a major challenge today and is described as "life threatening" in the banking industry. Compliance risk losses have often led to the down fall of many financial institutions (Mills, 2008).

Effectively managing Compliance risk is a top issue for company leaders today. This issue has been exacerbated because of the dynamic regulatory environment, recent fraud news, the ailing economy and unpredictable events. For many organizations, ineffective management of compliance risk has already resulted in unforeseen costs in terms of fines, penalties, corrective labor, and the inability to secure new business. These problems have ultimately impacted corporate profitability. From the available literature, very limited empirical evidence seems to confirm the relation between compliance risk management and firm performance. Furthermore, the empirical evidence that does exist suggests that the appropriate compliance risk management system may vary across firms. In other words, the relation between compliance risk management and firm performance is most likely contingent upon several firm-related factors.

From the reviewed literature, although Songole (2011), measured the relationship between risk and financial performance, the study did not address the specific issue of compliance risk management and its influence on financial performance. In addition, none of these studies were carried out in Rwanda Thus the study, therefore will sought to fill the gap by answering the question: Does compliance risk management influence financial performance of commercial banks in Rwanda?

1.3 Objectives of the study

1.3.1 General objective

The general objective of the study was to determine the influence of compliance risk management on financial performance of commercial banks in Rwanda.

1.3.2 Specific objectives

The study was guided by the following specific objectives:

i. To evaluate the influence of control environment on the financial performance of BK.
ii. To determine the influence of accountability on financial performance of BK.
iii. To investigate the influence of monitoring and evaluation on financial performance of BK.

1.4 Research questions

The research sought to answer the following questions

i. Does control environment influence financial performance of BK main Branch?
ii. Does accountability influence financial performance of BK main branch?
iii. Does monitoring and evaluation influence financial performance of BK main branch?

2.0 Conceptual Framework

Conceptual framework is a schematic presentation which identifies the variables that when put together explain the issue of concern (Peters, Elmendorf, Kandola & Chellaraj, 2000). It is a set of broad ideas used to explain the relationship between the independent variables (factors) and the dependent variables (outcome) (Coulthard, 2004).

In this study dependent variable was financial performance while the independent variables were control environment, Accountability and monitoring

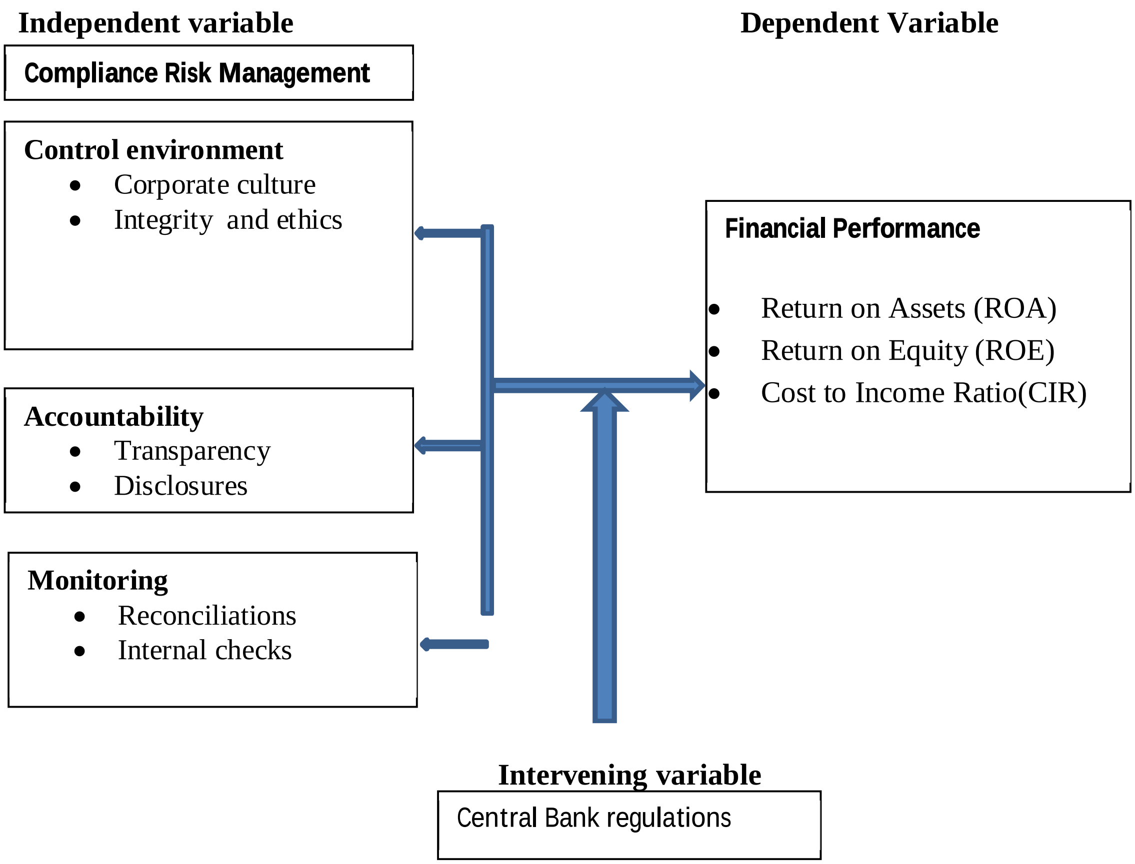

Figure 3: Conceptual framework

The study examined how compliance risk management influences financial performance of commercial banks. The aspects of compliance risk management are control environment (corporate culture, competence levels, quality of audit committee and management integrity and ethics), accountability (transparency and disclosures) and monitoring (reconciliations, internal checks and audits) as depicted by D'Aquila 1998; and Robert & Abbie 2003).

3.0 Research design

The research adopted descriptive survey design, which according to Mugenda and Mugenda (2003), descriptive design is a study undertaken in order to ascertain and be able to describe the characteristics of the variables of an interest in a situation. This research study considered gathering of consistent and accurate data that clearly describes the factors, as such, the participants answered questions administered through questionnaires. According to Merriam (1998) descriptive research design is used to obtain information concerning the current status of the phenomena to describe what exists with respect to variables. Descriptive study aims at collecting information about people's attitudes, opinion, and behavior (Orodho, 2002).

3.3 Target population

Population refers to the entire group of people/objects having common observable characteristics and is of interest to the researcher (Cooper & Schinders, 2008).It's also described as total of all that conforms to a given specifications (Kothari, 2008). The target population of the study was 250 employees in the following departments, Risk and compliance, internal audit, legal and credit departments based at Bank of Kigali head office.

3.4 Sampling Frame

According to Mugenda, (2008), sampling frame refers to the ultimate entities which may be people, households, organizations or other units of analysis. It is a physical representation of the target population and comprises all the units that are potential members of a sample (Kothari, 2008).

Table 2: Target Population

Departments	Target Population
Risk and Compliance	60
Legal	40
Internal audit	20
Credit	130
	250

4.1 Correlation analysis.

After generating the principal components of each variable of the study, the researcher came up with the main variables of the study which are control environment, accountability, monitoring and financial performance. After generating these main variables, correlation analysis was conducted to establish the relationships between them. Pearson's Correlation Coefficient was carried out and the results obtained are presented in table below.

Table 2: Correlation analysis

	Control environment	Accountability	Monitoring	Financial performance
Control environment	1			
Accountability	.3866**	1		
Monitoring	.13	.361**	1	
Financial performance	.293**	.363**	.340**	1

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

4.1.1 Relationship between control environment and financial Performance

Results from table 4.6 above reveal that there is a significant positive relationship between control environment and financial Performance (r = .293**, P-value < 0.01).

This implies that control environment as compliance risk management practice influences financial performance in Rwanda commercial banks.

4.1.2 Relationship between Accountability and financial Performance

The findings also disclosed a significant positive relationship between accountability and financial Performance (r = .363**, P-value < 0.01). Thus, implying that accountability as compliance risk management practice influences financial performance in Rwanda commercial banks.

4.1.3 Relationship between Monitoring and financial Performance

The findings indicated a significant positive relationship between monitoring and financial Performance (r = .340**, P-value < 0.01) thus, depicting that monitoring as compliance risk management practice influences financial performance in Rwanda commercial banks. .

4.1.4 Relationship between control environment, monitoring and accountability

The results in table 4.6 above indicate that there was a significant positive relationship between control environment and accountability (r = .386**, P-value < 0.01). This means accountability enhances control environment in Kenyan commercial banks. A significant positive relationship was observed between accountability and monitoring (r = .361**, Value < 0.01). This implies that accountability influences monitoring in Rwanda commercial banks.

5.0. Conclusions

Findings indicated that control environment has a significant positive relationship with financial performance (r = .293**, P-value < 0.01) in commercial banks in Rwanda. Banks follow their corporate culture, hold reasonably high competency levels, have quality audits and promote integrity through ethical values in their practices.

Results indicated that control environment and accountability are significantly positively related (r = .386**, P-value < 0.01) hence, they influence the operations of commercial banks. Strong control environment influences positively the consciousness of employees through having; competent employees, quality of audit committee and management integrity and ethical values of personnel. These enhance reconciliations and internal checks and audits, which promote transparency and disclosures. This result supports that strong control environment would not require stringent monitoring reconciliations, internal checks and audits for transparent accountability disclosures.

Findings according to ratios from published financial statements showed that financial performance in commercial banks was from 31% to 50% (mean = 3.4386).

In conclusion, accountability in commercial banks in Rwanda is well upheld in terms of disclosure and transparency indicating that accountability and disclosure are at the top of the agenda in commercial banks to restore the public trust. Further, monitoring exhibited in terms of reconciliation and internal check and audit is equally maintained in Commercial banks in Rwanda. Internal checks and internal audits help to prevent or help early detection of errors and fraud.

In this research, control environment involved corporate culture, competence levels, quality of audit committees and management integrity and ethics. This means that control environment in commercial banks is likely to influence financial performance. Thus in relation to the above, understanding the relationship between control environment and financial performance contributes to the sustainability of the banks' business. This is in agreement with Control environment aims at ensuring achievement of adequate financial performance.

5.1. Recommendations

From the findings, several recommendations are made. First, Commercial banks in Rwanda should maintain and strengthen control environment in order to increase their financial performance that enhances better operations in the financial market.

The banks also need to improve their liquidity level through increasing their current assets that can easily be converted into cash. This level of assets should be above the liabilities in order to meet the creditors' demands when there is need.

Local banks should consider Inter-bank lending as a source of financing to boost their liquidity at short notice and control the rate of loaning forms. Furthermore, the study recommends that commercial banks in Rwanda should consider transacting at a wide range of maturities. This allows borrowers to obtain the lowest rate of interest appropriate to their risk characteristics.

5.2. Areas for further research

This research was carried out using cross sectional approach, however longitudinal design can be used on the same topic and variables. In addition, Information and communication can be used as an independent variable to find out if it has any relationship with the financial performance.

In the subsequent research, there is a need to consider interviewing Bank directors, Management and the customers of the bank so that the customers' views are also captured instead of bank staff as in this case.

REFERENCES

1. Anderson, P. (1999), Complexity theory and Organization Science, *Organizational Science*. 10, (3) 216-232.
2. Ascher, W. (2000), Applying Classic Organization Theory to Sustainable Resource & Environmental Management. *Journal of Finance* 1 (1) 193-198.
3. Barnard, C. I. (1968), *The Functions of the Executive*. Cambridge: Harvard University Press.
4. Basel Committee, (2005), *Compliance and the compliance function in banks, Basel Committee,*
5. Basel. Barnard, C. I. (1968), *The Functions of the Executive*. Cambridge: Harvard University Press.
6. Beasley, M., Clune, R., Hermanson, D. (2005), "Enterprise Risk Management: An Empirical Analysis of Factors Associated with the Extent of Implementation," *Journal of Accounting and Public Policy*, 24 521-531.
7. Biegelman, M.T., Biegelman, D.R. (2008), *Building a World- Class Compliance Program. Best Practices and Strategies for Success.* John Wiley & Sons, Inc. 298 p.
8. Birindelli, G**.** (2008), Compliance risk in Italian banks: the results of a survey, *Journal of Financial Regulation and Compliance*, Vol. 1, No 4, pp. 335-351.
9. Boulding, K. (1956), "*General systems Theory – The skeleton of Science*", *Management Science*, April, 197-208.
10. Carreta, A., Farina, V. (2010), Assessing effectiveness and compliance of banking boards", *Journal of financial Regulation and compliance,* Vol.18, No.4, pp.356-369.
11. Carreta, A., Farina, V. (2010), Assessing effectiveness and compliance of banking boards, *Journal of financial Regulation and compliance,* 18, (4) 356-369.
12. Curtis, B., Kellner, M., Over, J. (1992), *Process modeling, Communications of the ACM,* 35, (9) 78-6.
13. D'Aquila, J. M. (1998), *Is the control environment related to financial reporting decisions?* Hagan School of Business, New York. NY.
14. Daft, R.L, (1992), *Organization Theory and design*. (4th Ed.) West Publishing, St Paul,
15. De Andres, P., Vallelado, E. (2008), "Corporate governance in banking: the role of the board of directors, *Journal of Banking and Finance*, 32, 2570-2580.
16. Diamond, D. (1984), Financial Intermediation and delegated monitoring, *Review of economic Studies* LI, 393-414.
17. Galbraith, J. (1982), *Design complex Organizations*. Addison-Wesley, Reading, MA
18. Johnson, R., Kast, F., Rosenzweig, J. (1967), *The theory and Management of systems*, 2nd edition, New York: McGraw-Hill.
19. Kelsey, M. (2004), Compliance risk: ensuring the risk taken is the risk intended, *ABA Bank Compliance Journal*, May/June, pp.4-9.
20. Kelsey, M. (2004), Compliance risk: ensuring the risk taken is the risk intended, *ABA Bank Compliance Journal*, 4-9.
21. Kiymaz, H. (2006), The Impact of Announced Motives, Financial Distress, and Industry Affiliation on Shareholders' Wealth: Evidence from Large Sell-offs, *Quarterly Journal of Business & Economics*, 45, (3-4) 69-89.
22. Kombo and Tromp (2006*), Research Methodology*. 2nd ed. Wiley Eastern Ltd. New Delhi
23. Krishnan, J. (2005), Audit Committee Quality and Internal Control: An Empirical Analysis, *The Accounting Review journal*, 80, (2) 649-675.

24. Lagzdins, A. (2011), Compliance risk management: on definition approaches. In: Proceedings of the 9th International Conference "Current Issues in Management of Business and Society Development - 2011", May 5-7, Riga, University of Latvia, 2011, page 378 – 387.
25. Majewski, T. (2006), Conflicts of interest chief compliance officers face in implementing compliance programs for investment funds and investment advisers, *Journal of Investment Compliance*, vol.7 Iss:4, pp.23-27.
26. Miledova, S., Nemcova, I. (2009), Building knowledge about strategy for growth: System dynamics approach, *Journal of European integration studies 2009,* 3. 107-110.
27. Mills, A. (2008), *Essential Strategies for Financial Services Compliance.* John Wiley &
28. Mugenda & Mugenda (2003*), Research methods* Nairobi: Nairobi publishers
29. Muhota, K. (2005), Check list for an internal Audit. *Giving Hope to World of Need*. USA.
30. Now it's All about Asking Questions. *Journal of Accounting* vol. 197, 2004.
31. Pagach, K., Warr, J. (2010), Theory of the firm Managerial behaviour, agency costs and ownership structure. *Journal of Financial Economics*, 3, 305-369.
32. Parker, C., Nielsen, L.V. (2009), Corporate Compliance systems: Could they make any difference, *Journal of Administration & Society*, 41 (1). 3-37.
33. Pascale, R. T. (1990), *Managing on the Edge.* New York: Simon & Schuster.
34. Price Water House Coopers (2004), 7th Annual Global CEO Survey-Managing Risk: An *Assessment of CEO Preparedness*.
35. Ramos, M. (2004), Evaluate the Control Environment: Documentation Is Only a Start;
36. *Research*, 16, (2) 347-380.
37. Robert, M. B., Abbie, J. S. (2003), Transparency, Financial Accounting Information and Corporate Governance: *New York Economic Policy Review* (April) 2003. USA.
38. Saucier, G., Goldberg, L. (1996), Evidence for the big five in analyses of familiar English personality adjectives. *European Journal of Personality*, 10, 61-77.
39. Shaw, D., Holland, C., Kawalek, P. (2007), Elements of business process management system: theory and practice", *Business Process Management Journal*, 13, (1) 97.
40. Sobel, P.J., Reding, K.F. (2004), Aligning Corporate Governance with Enterprise Risk Management, *Management Accounting Quarterly*, 5, (2) 29-37.
41. Sobol, R., (2009), Conversations at the top: the ton of the independent chief compliance officer, *Journal of Investment Compliance*, Vol.10, No.4, pp 10-15
42. Sons, Ltd.
43. Tse, S., Yaansah, R. (1999), An Analysis of Historical and Future-oriented Information in Accounting-Based Security Valuation Models, *Contemporary Accounting*
44. Verrecchia, R.E. (2001), Essays on disclosure, *Journal of Accounting and Economics*, 32 97-180.
45. Viswesvaran, C. (2006), Assessment of individual job performance: A review of the past century and a look ahead. *In Industrial Work & Organizational Psychology* Volume 1.
46. Willmot, H., (1995), what has been happening in organization theory and does it matter? *Personal review*. 24, (8) 33-53.
47. Wolosz, L., (2007), Sound policies and procedures: the basis of a sound compliance program, *Journal of Investment Compliance*, Vol.8, No.4, pp 7-11