Assessment of Financial Risk and Its Impact on an Informal Finance Institutions Profitability

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Abstract

This study examined the connection between financial risk and the profitability of informal financial institutions in Ondo state, Nigeria. Theory assumes risk to have a negative relationship with profitability; however, some studies have proved otherwise. This study used Anuoluwapo cooperative society located in Akure, over a quarterly 5-year period spanning 2015Q1 to 2020Q4. To assess the relationship between financial risk & profitability, the study employed the Pearson correlation to analyse the level of correlation. In assessing the relationship between financial risk & profitability, a data regression model was also used. The correlation coefficients for the variables were positive (+1) & negative (-1). The significance showing a clear indication that there is a strong correlation between financial risk & profitability in Anuoluwapo Cooperative Society. The data regression model shows that P value (0.00) is greater than 0.05; there is an insignificant but positive relationship between the profitability & the financial risk of Anuoluwapo Cooperative Society. This implies that the test considered the random effect model as the most appropriate estimator. The study found out that a unit increase in financial risk would lead to an increase in profitability. From the finding, the study concludes that financial risk positively affects profitability of Anuoluwapo Cooperative Society. The study suggests that since a high level of risk, yield high returns, the process of dealing with risk should be continuous & developing with time.

1. INTRODUCTION

Financial risk is any of various types of risk associated with financing, including financial transactions that include company loans in risk of default. Often it is understood to include only downside risk, meaning the potential for financial loss and uncertainty about its extent (Mcneil et al, 2015).

Risk is an uncertainty measure of the future payoff of an investment, measured for some time horizon relative to a certain benchmark. This implies that risk is a measure that can be quantified especially when comparing two potential investments one would want to identify and desire the less risky investment (Bessis and O'Kelly, 2015).

Financing gap is more important in a fast-changing knowledge-based economy because of the speed of innovation. Bamidele et al (2019) opined that Small and Medium-Scale Enterprises (SMEs) cannot find the financing they need, brilliant ideas may fall by the wayside and this represents a loss in potential growth for the economy. SMEs are usually faced with financial risks which if not mitigated will result into heavy losses that will eventually affect their profitability. SMEs are exposed to various forms of risks. Risk in whatever form is the likelihood of an event or action occurring with the possibility of a negative outcome.

However, risk associated with business may be classified as development risk, growth risk, environmental

risk, financial risk, manufacturing risk, operational risk, market risk, regulatory and legal risk, etc. The ability of Small and Medium enterprises to identify appropriately various forms of risks and to make appropriate decisions in tackling the risks will undoubtedly increase SMEs` profitability and economic growth in the country.

Despite the requirement for a comprehensive risk management program, SMEs carry out robust risk management and assessment strategies very rarely. The assessment of risk has largely been unsearched or ignored by researchers in Nigeria especially with respect to financial risk exposure, despite its crucial impact in SMEs profitability and growth. However, most SMEs might not be able to accommodate most of these risks in the course of their operations. This inability has direct impact on their performance, as it weakens their ability to achieve employment generation, economic growth, and sustainability. Hence, the aim of this study is to examine the impact of financial risk on profitability of informal financial institutions in Nigeria empirically.

2. REVIEW OF LITERATURE ON IMPACT OF FINANCIAL RISK ON THE PROFITABILITY OF INFORMAL FINANCIAL INSTITUTIONS

2.1 Theoretical Review of Literature on Impact of Financial Risk on the Profitability of Informal Financial Institutions

This chapter provides a survey of the relevant literatures and theoretical framework relating to the relationship between financial risk and profitability

2.1.1 Theoretical Exposition of Accounting Records in SMEs

Different opinions have continued to emerge on how accounting records can affect growth of the small scale businesses in Nigeria. Some aspects of the existing research delve into the relationship between record keeping and performance of firms.

Tanwongsval and Pinvanichkul (2008) comment on the reasons why SMEs prepare financial statements, and argue that on the list, SMEs rank assessing profitability second to the purpose of tax returns.

According to Ismail and King (2007), the development of a sound accounting system in SMEs hinge on owners level of accounting knowledge and skills.

Lalin and Sabir (2010), reports that the main drivers why SMEs prepare financial statements is pressure from regulatory authorities. Interestingly, however, others argue that the high cost of contracting professional accountants has left SME owners with no better option but to relegate management of accounting information (Evaraert *et al.*, 2006; Jayabalan and Dorasamy, 2009).

Zhou (2010) proposed the use of accounting software to improve accounting practices, albeit he laments the unavailability of medium-sized software for SMEs.

2.1.2 Financial Intermediation Theory

Financial intermediation in the banking sense is the process by which the banks take money from the depositors/savers (surplus parties) and transform it into different types of loans and advances and give to borrowers (deficit parties) (Alin, 2009; Greenbaum et. al, 2007). However, in the process of doing that, risk arises.

Credit risk arise as deposits are transformed into loans, liquidity risk arises because depositors' money has been lent to third parties. The market risk arises as banks would require liquidity in the financial market and find it exposed to market risk factors like interest rate, exchange rate, and equity risk (Greenbaum et. al, 2007).

The theory further assumed that financial intermediaries existed because the markets were imperfect. They posited that intermediaries would exist for as long as market imperfections were in existence and the converse was true (Bolton and Freixas, 2006).

However, the neoclassical model of a perfect market, the Arrow-Debreu world, assumed that complete markets meaning there were no market imperfections.

According to their research, there were no individuals that could influence prices and everyone in the market was a price taker. Borrowing and lending conditions were the same across all parties concerned and thirdly, the costs of acquiring information, performing transactions and those associated with insolvency were close to non-existent.

Fourthly the economies of scale and scope were absent and fifthly all market participants had ex ante and ex post immediate and full data on all elements and occasions pertinent to the (future) value of the transacted financial instruments (Anthony, 2012).

2.1.3 Enterprise Risk Management Theory (ERM)

A company can employ risk management through two major ways by either managing risk separately, or by managing all the risks together. Managing of risks together is referred to as enterprise risk management (ERM). According to Tseng (2007), Enterprise Risk Management (ERM) focuses on a consistent and systematic proven approach to manage various risks that a company is exposed to.

Gordon et al. (2009) explains ERM as the way an organization's exposure is managed to uncertainty by emphasizing on managing and identifying the events that could be preventing the organization from reaching it goals. ERM is applicable in all management levels of the firm.

According to Committee of Sponsoring Organizations (COSO) (2004), Enterprise risk management is a way, that the management, board of directors and other staff in the organization effects. ERM identifies potential events that might hit the organization, is applied across the enterprise

in strategy setting, management of risk within the risk appetite, and provide reasonable assurance towards entity objectives achievement.

ERM looks at various methods that an organization's risk manager con concentrates on intellectual assets, people, brand values, skills, business expertise, the regulatory environment, principle source of profit stream (Searle, 2008).

This helps an organization to balance business pressures like delivering success to stakeholders and manage risks to sustain the business. The risk constantly monitors the risk exposure and is positioned to change strategy and ensure risk is at manageable level. The theory is applicable to the study by outlining the steps of managing financial risks.

2.1.4 Finance Distress Theory

Baldwin and Scott (1983) purported that when a firm's business deteriorates to the point where it cannot meet its financial obligation, the firm is said to have entered the state of financial distress. The first signals of financial distress are violations of debt payments and failure or reduction of dividends payouts.

Whitaker (1999) defines entry in financial distress as the first year in which cash flows are less than current maturities' long-term debt. The firm has enough to pay its creditors as long as the cash flows exceed the current debt obligations. The key factor in identifying firms in financial distress is their inability to meet contractual debt obligations.

However, substantial financial distress effects are incurred well prior to default. Firms enter into financial distress as a result of economic distress, declines in their performance and poor management especially on risks. This depicts a process of a financial distress that begins with an incubation period characterized by a set of bad economic conditions and poor management which commits costly mistakes.

In the case of commercial banks, in ability to provide cash to depositors and loans to borrowers as and when the demand may constitute a liquidity crisis. Other creditors also need to be taken into account when firms are putting in place risk management measures. Credit risks in banks also need to be addressed since it may lead to financial distress. Loan portfolio management is an important determinant of the firm's liquidity. The banks should manage the credit and liquidity risk in order to avoid the financial distress. The theory of financial distress emanates from the liquidity and credit risk facing a firm.

This theory provides for a non-biased perspective on the relationship between credit risk and financial performance variables employed by the study. By providing information that the effects of financial distress occurs prior default risk, the theory offers a neutral platform to undertake an incisive empirical analysis of this relationship within the commercial banks.

2.1.5 Liquidity Preference Theory

This looks at interest rates from the perspective of supply and demand of money in the banking sector. The theory was first established by Keynes (1936) where he specified that the demand for money is expressed as a function of level of income and interest rate. MD=f(Y, r) where: MD = money demanded, Y =Level of income and r = interest rate. This structure holds that the loan fee is dictated by the connection of market activity of cash stock. According to Keynes (1936) cash is requested for the most part for the accompanying intentions; as a medium of exchange, for security reasons and speculative reasons. He additionally expressed that financial specialists will dependably favour short-term securities to long-term securities. The only incentive that can make investors choose long term securities is when they yield great amounts in interest as compared to short-term ones. Along these lines, the trend in terms of yield will dependably be upward inclining. This is dependent on the perception that, all factors constant, individuals like to clutch money (liquidity) and that they will request a premium for putting resources into non-liquid resources, for example, securities, stocks, and land.

The hypothesis proposed that the premium requested for separating with money increments as the term for recovering the money increased. (Tonye and Priye, 2014). The transactions demand for money relates to the need for cash and to meet current assets and business transactions (Okpara, 2010). Auerbach (1988) postulated that the rate in increment of the premium backed off with the expansion in the period for recovering the money. In money related terms, this hypothesis is communicated as forward rates ought to surpass the future spot rates. Indaba (2011) stated that the expectation about changes in bond prices or in current market interest rates determines the speculative demand for money. According to Reilly and Norton (2006), the hypothesis of liquidity inclination holds that long-term securities ought to give higher returns than short-term commitments since financial specialists will give up a few respects put resources into short maturity commitments to keep away from the higher price instability of long maturity bonds. This study will employ lending interest rate to proxy effect of interest rate on profitability which is affected by the demand of money (loans). According to Huang, J. Sun, Z., Yao, T., and Tong, Y. (2014) a measurable connection exists between liquidity preference and loanable size amount, as both are affected by the level of interest rate.

2.1.6 Shift-Ability Theory

Allusion by Toby (2006) to the foundation of liquidity risk in the history of United States of America banks with the Shift-ability Theory of the banking system which explicated that the liquidity of a bank hinges on its ability to move its assets (e.g. short term instruments) to another institution at a reasonable price. When this theory was formulated sentiments in cases where the huge number

of investors would withdraw their investments, the banks would trade investor portfolios so as to pay off the money acquired by the investors. One of the founding fathers of this theory avowed that Liquidity is equivalent to Shift-ability. Shift-ability theory was therefore the main tool that readdressed the traditional idea that the bank should finance its operations through loans to a new doctrine that investments could also be used as a source of liquidity.

However, the shortfall of this theory was that even though an individual bank might be able to meet its liquidity requirements through the shifting of assets, the sentiments may not be possible for all banks combined. This argument was due to the fact that not all banks had adequate cash to shift to other banks. This caused a bit of a mismatch in the banking sector during 1930s as all or most banks wanted to be sellers not buyers; because of this mismatch, financial analyst said what was required were the external agents that would intermediate or perhaps inject cash into the banking system so as to take a position of a buyer as all banks wanted to be sellers (Toby, 2006). Unfortunately, the US Federal Reserve Bank could not intervene resulting in the crashing of most banks (Toby, 2006). Nonetheless, this study will utilise stock market development (market capitalisation) to proxy capital markets ability to generate liquidity as shift-ability assumed that focusing more on investing would improve liquidity.

2.1.7 New Institutional Economics Theory

According to Williamson (1998), this theory predicts that risk management practices may be determined by institutions or accepted practice within a market or industry. Further, 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. Firms in regulated industries provide top management with few opportunities for discretion in corporate investment and financing decisions. Smith and Watts (1992) showed that 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 hedge firm risk. 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 financial risk management is positively related to measures of the firm's investment opportunity set proxies.

3. EMPIRICAL REVIEW OF LITERATURE ON IMPACT OF FINANCIAL RISK ON THE PROFITABILITY OF INFORMAL FINANCIAL INSTITUTIONS

This chapter provides a survey of the relevant literatures relating to the relationship between financial risk and profitability.

3.1 International

Akong'a, (2014) in her study analyzed the current financial risk management practices of 44 commercial banks using multiple regression model and financial risk management. The current challenges' facing the financial services industry includes customer retention, financial risk, legal and compliance risk, strategic risk, technological risk and stiff competition from MFIs, mortgage firms and SACCOs. The problem facing Kenyan banking sector focused in this study is the effect of financial risk on the profitability.

Therefore, Leonard Embeywa mudanya, and Prof. Willy Muturi (2018) in their study therefore sought to fill the existing research gap by conducting study to establish the effects of financial risk on profitability of commercial banks listed in the Nairobi Securities Exchange. The study used quantitative research design. Time Series Cross Sectional (TSCS) data was used to establish the effects of financial risk on profitability of commercial banks listed in the Nairobi Securities Exchange. Panel data estimation technique was adopted because it takes care of heterogeneity associated with individual banks by allowing for individual specific variables. The target population of this study comprised of all the 11 commercial banks in Kenya that are listed in the Nairobi Securities Exchange. The study employed secondary data that was extracted from audited financial statements and annual reports of listed commercial banks over the 10-year period, 2007 to 2016. This data was collected through a data collection form. Data was obtained for the last ten years (2007 to 2016).The secondary data was quantitative in nature (continuous data). The collected quantitative data was edited and coded and entered into a Stata version 14 for analysis. Both descriptive and inferential statistics was used to analyses the quantitative data. In descriptive statistics, the study used frequency distributions, mean, standard deviation and percentages. The time series analysis tests that were performed on the model include correlation analysis, normality test, Heteroscedasticity Test, Autocorrelation, Linearity test, Stationarity and Unit Root Test and Co-integration test. The study established that there was a strong correlation between profitability and credit risk; this strong relationship was found to be statistically significant. The study found that an increase in market risk would lead to decrease in profitability. The study revealed there was strong correlation between profitability and market risk. The study found that an increase in credit risk would lead to decrease in profitability. The study found that increase in liquidity risk would lead to decrease in profitability. The study also found that liquidity risk was statistically significant in affecting profitability of commercial banks.

According to Omasete, (2014) on the effect of risk management on financial performance of insurance

companies in Kenya; risk management techniques were studied and risk Identification was found to be the most significant influencing financial performance of insurance company. Risk management has become the driving force for business success due to the ever-changing business environment.

William Chiliya, et al. (2015) in their study investigated the impact of the level of awareness and use of risk management techniques on the financial performance. The data was collected from 82 of Small Medium Enterprises (SMEs) owners/managers in the construction industry in Eastern Cape, South Africa. The results show that the level of awareness and use of risk management techniques have a significant impact on the financial performance of SMEs in the construction industry. The study recommends that the government, tertiary institutions, construction industry development board, and SME owners or managers in the construction industry should work together in improving the level of awareness and use of risk management techniques.

Ameni Ghenimi, et al (2017) in their study investigated the main sources of banking fragility. They used a sample of 49 banks operating in the MENA region over the period 2006 to 2013 to analyze the relationship between credit risk and liquidity risk and its impact on bank stability. Their results showed that credit risk and liquidity risk do not have an economically meaningful reciprocal contemporaneous or time lagged relationship. However, both risks separately influence bank stability and their interaction contributes to bank instability. These findings provide bank managers with more understanding of bank risk and serve as an underpinning for recent regulatory efforts aimed at strengthening the joint risk management of liquidity and credit risks.

3.2 Domestic

Various studies have been done on the Small and Medium Enterprises' contribution to the Nigerian economic growth, but only few have addressed how financial risks affect it.

Offiong et al. (2019) in their study investigated how financial risk affects SMEs` performance. In other to achieve the objective of the study, exploratory research design was used and data were sourced from Central Bank of Nigeria (CBN) statistical bulletin from 1986 to 2017. The study used Auto-Regressive Distributed Lag (ARDL) techniques as the tool of analysis. The result revealed a negative and insignificant relationship between financial risk and SMEs` performance in Nigeria in the long run. However, exchange rate risk, liquidity risk, interest rate risk and inflation risk have a significant, but negative impact on small and medium enterprises in the short run, as well as the long run. Financial risk adversely affects the performance of Nigerian SMEs and, therefore, should be controlled to enhance their performance.

3.3 Methodology

$$y_i = f(\beta) + e_i$$

Where:

y_i = profitability

f = function

x_i = financial risk

β = unknown parameters

e_i = Error term

3.4 Result

This chapter presented the research findings, their interpretation and discussion. Data was collected from financial statement of the members of the cooperative society. The study investigated the impact of financial risk on the profitability of Anuoluwapo cooperative society in Akure, Ondo state. The research findings are presented using both descriptive and inferential analysis. The results of the financial risk were presented in tables and an explanation given. This chapter has been concluded by looking at a detailed interpretation of the findings on the financial risk and the profitability of Anuoluwapo cooperative society.

3.5 Descriptive Statistics

Table 1
Descriptive Statistics

	Profitability	Financial_risk
Mean	15.02658	406.6453
Median	14.28685	421.3639
Maximum	22.31843	584.5573
Minimum	8.303694	149.4416
Std. Dev.	5.177073	148.4131
Probability	0.441027	0.377051
Observations	20	20

Source: Author (2021)

The result from Table 1 shows the mean score, median, maximum, minimum, standard deviation, probability, and the observation on the profitability and financial risk of the study. The mean score recorded shows that the financial risk has more risk on the profitability at 96% based on the study carried out. The median result shows high financial risk on the profitability of the outcome on organization. The maximum and the minimum of the result have high financial risk on the profitability on the income of the organization. The observation on the results shows that there is possibility of financial risk having higher variability on profitability of the organization.

3.6 Correlation

Correlation analysis are used to test whether a relationship exists between two variables and often range between (-1) strong negative correlation and (+1) perfect positive correlation. The study employed the Pearson correlation to analyse the level of correlation.

Table 2
Correlation Analysis

	Financial risk	**Profitability**
Financial_risk	1.000000	0.412617
Profitability	0.412617	1.000000

Source: Author (2021)

Result from the Table 2, Correlation coefficient varies from -1 to +1 coefficient is an indication of a

Table 3
Regression Analysis

Dependent Variable: Profitability

Method: Least Squares

Sample: 2015Q1 2019Q4

Included observations: 20

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Financial risk	0.014393	0.007489	1.921807	0.0706
C	9.173631	3.232500	2.837937	0.0109
R-squared	0.70252	Mean dependent var		15.02658
Adjusted R-squared	0.45155	S.D. dependent var		5.177073
S.E. of regression	4.845046	Akaike info criterion		6.088430
Sum squared resid	422.5404	Schwarz criterion		6.188003
Log likelihood	-58.88430	Hannan-Quinn criter.		6.107868
F-statistic	3.693343	Durbin-Watson stat		0.159396
Prob(F-statistic)	0.070606			

Source: Author (2021)

The value of R-square was an indication of a positive significant effect of financial risk on profitability. The adjusted R-square of 0.45155 shows that the data fits the model

The result from Table 3. shows that P value (0.00) is greater than 0.05; there is a positive significant relationship between the profitability and the financial risk of Anuoluwapo Cooperative Society (ACS) for the period of 2015 to 2020. This implies that the test considered the random effect model as the most appropriate estimator.

3.7 Test of Research Hypothesis

HO: There is no significant relationship between the financial risk and the profitability of Anuoluwapo Cooperative Society

HA: There is a significant relationship between the financial risk and the profitability of Anuoluwapo Cooperative Society.

This implies that the result from Table 3 shows that P value (0.00) is greater than 0.05; this therefore implies that there exist a positive and significant relationship between the profitability and the financial risk of Anuoluwapo Cooperative Society, for the period of 2015-2020. (Pearson correlation)

3.8 Policy Implication of This Study

In conclusion, this implies that the growth and

perfect correlation. In this research paper, the correlation coefficients for the variables were positive (+1) and negative (-1). The significance showing a clear indication that there is a positive correlation between financial risk and profitability in Anuoluwapo Cooperative Society. This indicates that the higher the financial risk, the higher the profitability.

performance of an informal indigenous financial institution is solely not determined by the internal factors rather the external factors such as the government policies, global shocks (e.g. COVID-19 lockdown). A measure does create a great impact on the profitability of business firm.

For business firm to grow there's need for government and stakeholders to promote and facilitate the enabling environment for business to grow in terms of profitability.

CONCLUSION

To examine the impact of financial risk on Anuoluwapo Cooperative Society profitability for the period of 2015-2020. To measure the impact of financial risk on profitability, a data regression model and correlation analysis was employed. In this research paper, the correlation coefficients for the variables were positive (+1) and negative (-1). The significance showing a clear indication that there is a positive correlation between financial risk and profitability in Anuoluwapo Cooperative Society. The result from Table 1 shows that P value (0.00) is greater than 0.05; there is a positive relationship between the profitability and the financial risk of Anuoluwapo Cooperative Society. This implies that the test considered the random effect model as the most appropriate estimator.

The study established that there was a strong positive correlation between profitability and financial risk; this strong relationship was found to be statistically significant. The study found out that a unit increase in financial risk would lead to an increase in profitability. From the finding, the study concludes that financial risk positively affects profitability of Anuoluwapo Cooperative Society during the period of 2015 to 2020. Ugah (2020) in his study on financial risk management and bank profitability in Nigeria, also affirms similar result for Access bank of Nigeria

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