

## ABSTRACT

Kenyan banking sector is exposed to risks that initiate from external and internal environments. Operational risk threatens the viability and long-term sustainability of banks. Despite growth in the Kenyan banking sector, operational risk possesses a major challenge therefore, this study examined the impact of operational risk on the financial health of tier two and three commercial banks in Kenya. The inquiry adopted a quantitative research concept with a target population of 36 commercial banks licensed by CBK by December 2017. The banks were grouped under tier two and tier-three categories. Time Series Cross-Sectional unbalanced secondary panel data was analyzed. The panel Data was unbalanced as some of the data was unavailable over the years due to banks that had collapsed merged or bought out. The data was derived from published financial statements of accounts of the 36 commercial banks in Kenya, the CBK annual reports and the Banking survey publications for nine years from 2008 to 2016. Fixed effect dummy variable Regression analysis was applied to establish the effect of Operational risk management on the financial health of tier-two and tier-three commercial banks in Kenya. The dependent variable of the study was the financial performance of tier two and three commercial banks in Kenya and this was measured using the return on equity and return on assets as a percentage. The other variables included the bank size which was measured by a natural logarithm of total assets and operational risk was measured by the cost to income ratio as a percentage. The qualitative variables operational risk management practices, board and senior management oversight were difficult to measure and they were in cooperated in the dummy variable measure categorized under Tier two and Tier three. Under the dummy variable each bank was assigned a value of one if it fell under tier two categories and zero if it falls under tier three. Financial ratio analysis was used in the study together with panel data techniques of fixed effects and panels least squares. Hausmann test was carried out to test whether fixed effect is superior to random effects. Diagnostic tests were carried out to detect any econometric problems the regression models might possess. The study findings indicated that operational risk has a significant negative effect on the financial performance of tier two and three banks. Bank size has a significant positive effect on the financial performance of tier two and three banks. The conclusion of the study was that financial performance of tier two and three banks has an inverse relationship with operational risk which was measured by cost to income ratio. The study also concluded that tier three banks are not able to mitigate operational risks as well as tier two banks through the dummy variable measure. Banks are therefore encouraged to develop effective risk management and measurements techniques to avoid huge operational losses that negatively affect the financial health of the institutions.