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Journal of Advanced Research in Business and Management Studies

Journal homepage: www.akademiabaru.com/arbms.html
ISSN: 2462-1935

Open Access

The Risk Management Committee and Bank Stability: A Proposed Framework

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ARTICLE INFO

Article history:
Received 23 April 2018
Received in revised form 23 June 2018
Accepted 27 June 2018
Available online 3 July 2018

ABSTRACT

The recent spate of bank crisis in Nigeria and the instability that accompanied it in several banks necessitated the need to find out the underlying cause and proffer solutions. This proposed framework is aimed at examining the roles of the risk committee in the crisis. The objective is to investigate the relationship between the risk management committee and bank stability in Nigeria. The framework presents the attributes of the risk management committee that could have impact on bank stability. It also presents the agency and resource dependence theories as relevant to the investigation. Given that this is a proposed framework, it is subject to review. If it is validated, it would contribute towards providing insight into the roles of the risk management committee in Nigerian banks and aid policy formulation on risk governance..

Keywords:
Bank stability, expertise, risk management committee, oversight

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1. Introduction

Banks occupy an important place in the financial system of every country [7]. They are the links between savings and investment given that banks channel funds from depositors to borrowers for personal and business purposes [32]. This duty of deposit acceptance and lending for longer term to borrowers is called transformation of maturity. Banks facilitate payments and ensure the smooth distribution of currency within a country. Thus, through deposit acceptance, lending and facilitating the payment system, banks play vital roles in promoting economic activities and ensuring the smooth functioning of the economy [7]. Consequently, the health of banks is of paramount interest to financial authorities in order to guide against insolvency and instability [12, 54].

A bank that is exposed to insolvency is having less cash to pay its obligations as at when due. This could arise from the consequences of past decisions on credits that turn delinquent or from misconducts usually regarded as moral hazards. Regardless of what precipitates a bank crisis, the implications are of wide ramifications for the economy and the individuals [13, 40]. Bank crisis could result in sharp reductions in bank credits and drops in investment and growth. Also, bank customers

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whose demands for cash could not be met may panic and request for their deposits which could lead to bank runs with grave consequences even for sound banks [32, 39, 40, 60]. The exposure of other banks in the system when one bank or a few banks are facing crisis is what is referred to as contagion which is linked to the interconnectedness of the banking system [14, 40, 42, 55].Thus, as a result of the economic significance of banks and the far reaching implications of a bank crisis, financial regulators closely monitor the banking system to ensure stability [13].

Confidence in the stability of banks is vital for the smooth running of the financial system and an important ingredient for a well-functioning economy [57]. However, for the financial system to be reliable and banks in particular to be sound, there is a need for good internal governance [27]. The internal governance of corporate organisations and in particular banks has come under the radar of scholars and international bodies in recent years [4, 25, 28, 40]. This focus has been more intense since the global financial crisis given the connections suggested between the crisis and weak internal governance especially risk governance in banks [28, 41]. The increased attention is linked to efforts designed to improve the poor internal governance and enhance risk governance with the aim of strengthening risk management.

In several globally systemic important banks, the weak governance contributed to slack and ineffective internal checks. Thus, inefficient governance generated poor board and committee oversight [28, 40]. Weaknesses in the monitoring of management seems to have given room to poor risk management strategies which encouraged excessive risk taking. This poor oversight of managerial risk taking decision is widely suggested as a contributory factor to the global financial crisis [8].

Similarly, in Nigeria, boards seem to fail in understanding the roles assigned to them as they grappled with the supervision of complex and sophisticated banking firms which are also opaque [57]. Boards and their committees' roles in risk governance as the backbone of effective risk management were not properly understood and this prevented the implementation of appropriate policies for sound risk oversight and management [40, 49, 56]. Thus, failing to constrain managerial risk taking as demanded by their roles, the boards of banks and their committees allowed the executives to operate freely and without restraint which generated a rapid growth in risky assets that plunged exposed institutions into instability, insolvency and in severe cases the collapse of the affected banks.

In failed institutions, there were signals of poor internal control systems and inefficient risk management [28, 40, 50]. There seems to be a lack of effective integration of risk control mechanisms coupled with the inability of the boards and their committees to adopt a holistic approach to risk management. Internal control resources seem to be inadequate while expertise was lacking in some instances [28, 40]. Where expertise exists, the inputs were disregarded to the detriment of the health of banks [56]. On the other hand, good internal governance which encompasses sound risk governance practices assisted some banks to do better and survived [28]. Banks that performed better were found to have emplaced the right risk management strategies, defined their risks with a specified risk appetite. Also, the right risk governance framework which established the risk management committee (RMC) and recognised the chief risk officer (CRO) and the line of reporting to both the chief executive officer (CEO) and the board were duly implemented [2,8 45].

Thus, it is important to examine the internal governance and risk system failures at the board and committee levels in the Nigerian banking system. This risk governance failure is closely connected with poor risk oversight and unsound risk management [48, 56]. An investigation into this poorly designed risk governance system would provide insight into how to address the detrimental outcomes of weak internal governance and poor risk management. One of the measures expected to provide strong risk governance in banks is the establishment of a risk management committee

(RMC) [9, 27]. This is a committee dedicated to supporting the oversight of the board on all matters relating to risks. Complementing this is the dedicated risk function which is usually represented by the office of a chief risk officer (CRO). In Nigeria which is the focus of this study, the code of governance provided for the establishment of the afore-mentioned structures of risk governance [18-19]. Despite these provisions, bank instability still continues to plague the Nigerian banking sector.

Bank instability in Nigeria dates back to the pre-independence period. In that time, banks failed in succession due to lack of legal and regulatory provisions to guide banking business and protect the stability of institutions [2]. Relative stability was restored after the establishment of the Central Bank of Nigeria in 1959 [48]. However, following the deregulation of the economy in 1986 when banking license issuance was libralised, there was an upsurge in the number of banks between 1986 and 2000 [48]. Given the lack of enabling governance and regulatory environment for the large number of banks, unethical practices mainly connected with shareholders and boards began to permeate the system. Soon, the institutions began to experience insolvency and widespread instability [48]. The trend continued to post 2010.

The instability in the Nigerian banking system seems to be linked to lack of effective credit control which resulted in high level of non-performing loans. Connected and insider credits were not collaterised [56]. Lending to directors and diversion of bank funds by the chief executive officers crippled the banks and instigated a systemic crisis in 2009 from which the Nigerian banking system has not fully recovered [56]. Banks' boards seem to either looked the other way or actively participated and aided the actions of the executives [56]. [50] notes that committees of the boards failed in the discharge of their duties. For instance, [56] indicates that the RMC could not control bank risk taking which resulted in high levels of poor credits. The trend still subsisted in 2016 when the board and its committees in one of the systemically important banks were dissolved because of the failure of risk governance and management. The affected bank experienced deteriorating capital and rising non-performing loans [17]. The central bank concluded that the risk committee seemed to be negligent. Given the importance of the RMC in the oversight of credit management to check poor lending decisions, the committees seem to have either yielded to pressure or failed to act decisively. This study is therefore proposed to examine the roles that the RMC could likely have played in the instability experienced in the Nigerian banking system.

The study is divided into the following sections: the introduction comes up in section I. In sections II and III the literature review and research framework are presented while the conclusion is contained in section IV.

2. Literature Review

2.1 Bank Stability

Banking system stability is a desirable goal for every economy due to the importance of banks in the financial services industry and the far reaching implications of instability in banks [6]. A banking system is considered to be stable when over a reasonable period of time it is able to experience relative freedom from systemic shocks and disturbances with internal built-in measures that would enhance self-correction and prevent crisis [5, 20, 57]. Also, a stable banking system would be required to possess sound internal governance [62] without which supervisory actions would be ineffective. Thus, when a banking system is stable, the institutions would perform their functions of intermediation, credit allocation, and facilitating the payment system without the expectation of sudden interruptions [58]. Banking system stability is important for economic growth and development [15]. Banks are involved in the payment system; they facilitate the flow of funds from savers to borrowers which is a necessary condition for investment [15]. Also, without banks, the

conduct of trades at local or global scales would be very challenging if not almost impossible [7, 13]. Thus, a stable banking system is vital for a smooth running economy.

While bank stability is vital, it is also possible for banks to suddenly experience shocks that could set instability in motion. Bank instability occurs when a major institution or some banks within a country face challenges that create liquidity gaps resulting in their inability to meet payment obligations [59]. If the condition is not quickly tackled, it could spread rapidly to other institutions and even beyond the borders and create regional or even global instability [55, 59]. This spread of crisis from one region to another is the reason why banking crisis is described as contagious. Therefore, financial authorities are concerned about the implications of instability in banks and pay close attention through supervision and regulation to oversee and ensure sound health for banks [3, 5, 59].

2.2 The Risk Management Committee (RMC)

The RMC is dedicated to the oversight of risk management and supports the board in ensuring effective risk governance. It is responsible for the design of bank risk policy and oversees management's implementation of approved strategies [9]. The committee assists the board in considering and recommending the risk appetite and embarks on periodic review of a bank's risk profile. To ensure that risk is well implemented, the committee conducts a periodic check of risk management and control framework. The RMC also recommends important policy statements to the board that are connected with supervision and regulation. These include vital issues such as loan concentration, exposure of banks to large borrowers and provisioning for impairment. For effective service, the committee is expected to possess the expertise and skills required for risk management at the very high level of an organisation such as banks. It also guides the board in all matters relating to risk during board deliberations [9, 35].

Studies on the relationship between the RMC and bank stability are few. However, among these studies, the available evidence, though mainly from developed economies suggests that the presence of a RMC could enhance banking system stability. For example, in a 2008 study by [45], they report that only 12 of the 20 largest US banks had RMC before the global financial crisis. A fact they noted could have facilitated the crisis. [38] also note that the absence of a RMC in a bank could aid instability.

[42] investigate the risk management committee and its characteristics in their study of selected US banks after the enactment of the Dodd-Frank Act. Their research focused on the relationship between the risk management committee, risk taking and the performance of bank holding companies. They report that the number of members on the RMC, the number of meetings and the proportion of independent members on the committee have significant and negative relationship with risk taking. They also find that the presence of a RMC was negatively and significantly related to risk. The results suggest that banks that establish a RMC could control and reduce risk better than banks without a RMC. It also indicates that risk control and management would be enhanced with a committee that meets regularly, having independent directors where the members are not few. The result also shows that the presence of a RMC and all its characteristics have positive and significant association with the performance of bank holding companies (BHC). The foregoing indicates that the risk management committee could be an important instrument at the disposal of the board to restrain management in decisions that could expose banks to risk and instability. It further demonstrates that the establishment of a RMC is important for bank risk control and management in order to promote stability.

Prior studies suggest that the attributes of the RMC such as the size, expertise, meetings, gender and independence could play important roles in risk governance and aid bank boards in the oversight of managerial decision making [4, 10, 28, 43, 47].Thus, the RMC and the afore mentioned attributes demand further exploration to determine the roles they could play in bank stability.

2.3 The RMC Size

The size of a board's committee is an important determinant of its effectiveness [65]. The size of a committee is determined by the number of members appointed to its service but there is no consensus on the acceptable size. In countries such as the US and the UK, it ranges from three to five or six [25, 53]. Large committees are considered as providing diversity such as gender, expertise and other resources [11]. However, a large committee could also create challenges of effective coordination and smooth communication. A smaller committee is likely to have the advantage of faster coordination given that the members could be easily consulted but it would also lack the additional resources and diversity of a larger committee [47, 65]. However, in the banking sector, given the sophisticated and complex nature of banking, a small committee may face some challenges in rendering service.

While studies on the RMC size and bank stability are scanty, there are others which investigated the size of the RMC and risk. For instance, [47] in their Malaysian study find a significant and negative relationship between the RMC size and risk taking. They concluded that if the RMC could facilitate reduction in risks, the committee could be vital towards the attainment of bank stability. Similarly, [61] found that the size of the RMC has a negative association with increased risk in the companies investigated. Hence, as the committee size increases, it could have more resources to perform its functions. This indicates that the resources available through the size of the RMC have the capacity to constrain managerial actions that could increase risk. Thus, by checking the risk taking behaviour of the executive, more members on the committee would likely contribute to the soundness and stability of banks.

2.5 The RMC Expertise

The presence of directors with expertise in accounting, risk management and finance could be vital to the effective functioning of the risk management committee [24, 38]. Understanding the nature of risks faced by banks is vital for the members of the RMC and to achieve this, they require some knowledge of finance and risk [38]. On the other hand, lack of expertise in these fields could hinder the members and limit the impact of the committee especially during challenging times [67]. Standards and codes such as the Nigerian code of governance specified the necessity for the RMC members to possess financial and risk expertise [18-19].

In a study conducted by [31], they report a positive and significant impact for the directors who have financial expertise than those without it. The finding suggests that expertise in finance and risk could assist such members to be more effective since reports and proposals presented at meetings would not be difficult for them to understand. Their finding is consistent with the reports of [63] on the importance of financial expertise for the members of the RMC. The studies suggest that the expertise of the RMC members in risk and financial matters could constrain managerial decisions and play important roles in the stability of the banking system. However, financial experts could also align with shareholders and favour more risks. [4] indicate that in 2007-2008 during the global financial crisis, financial experts did not aid banks to perform better hence they experienced instability. Nevertheless, the presence of experts in finance and risk management is considered a vital attribute

of the RMC that could support risk management and control. Consequently, national and international standards contain provisions for the inclusion of financial experts on the RMC with the goal of promoting bank stability [9, 18-19].

2.4 The RMC Meeting

Meeting attendance indicates that committee members are active participants in the activities of their groups. It provides them with the opportunity to discuss important issues and advise management [64]. In the risk management committee, it gives members the chance to examine executive policies on risk management, decide on the bank's risk appetite and strategies with a view towards ensuring sound risk control. [22] in their 2006-2007 study report that attendance at meetings has a positive and significant association with firm performance. They suggest that frequency of meetings of the RMC could contribute to bank stability as it has the likelihood to afford members more time and opportunity to examine proposals critically and guide managerial decisions effectively. Similarly, [4] find that in the US, during the global financial crisis, the frequency of meetings of the RMC has a significant and positive impact on the stability of banks given that it aided the performance of banks that held frequent meetings. Perhaps, the members were able to make informed contributions that assisted management to implement better risk control.

The foregoing studies suggest that an effective RMC would require regular meetings so as to spend more time in the oversight of management especially in discussing important issues that could have significant implications on bank assets. On the other hand, the frequency of meetings alone may not be adequate to ensure stability in banks. [4] note that attendance should go hand in hand with the commitment of members towards committee responsibility especially making informed contributions. They argued that the frequency of meeting may not aid a bank to be stable if members meet but fail to show dedications to their tasks. Consequently, such meetings may not be productive. However, committee meetings still remain the only vital place that members' voices could be heard and far reaching decisions taken that would promote stability in banks.

2.5 The RMC Gender

The gender of a committee is the proportion of the female members to total committee membership [44, 60]. The literature argue that female committee members could likely serve as complimentary device for governance control [1]. [16] indicated that the inclusion of more female members on corporate boards and committees has gained attention in recent times. This seems to stem from the argument that more female membership represents increased diversity and this is likely to contribute more resources and lead to better decisions [33]. Gender differences could be observed in communications, decision making and style of leadership [37, 58]. This difference between the genders could translate to more robust decisions on risk management. [44] contend that female involvement in corporate affairs is not just a means to an end, but an important element in that such participation would not only engender equity but provide a different perspective during discussions. Thus, diversity could be beneficial to the RMC.

Women seem to have behavioural differences compared with men as it is observed that females prefer less risk to males [23, 33, 46]. Men are also more likely than women to take extreme risks [66]. Women who serve as executives issue less debts than their men counterparts. Therefore, the female members of the RMC could serve as counter force to their male members. Hence, the female members of the RMC could serve as more effective checks on executive risk taking and thereby enhance bank stability. Therefore, given that the presence of female members on the RMC could

contribute to less risk taking, it is expected to ensure better quality of assets and consequently promote the stability of banks. Nevertheless, diverse groups also could bring challenges and strives as a result of conflicts from differences in opinions and prolong decision making with detrimental consequences [21].

2.6 The RMC Independence

The effective functioning of board committees is dependent on their composition [51]. If the committee is composed of more independent directors, there is a likelihood that members could be more effective in the oversight of management. This is because where the executive are unable to influence independent board and committee members, the directors tend to perform better [4, 61]. Independent members would likely have the capacity to scrutinize executive proposals more objectively because of less pressure from management [29]. Consequently, they could demand for vital information necessary for the review of managerial presentations. The enhanced oversight could produce better decisions on policies and strategies and contribute to stability. Moreover, the independent members usually strive to protect their reputations which necessitate that they provide more effective monitoring [29]. Their reputation is enhanced when the banks in which they serve remain stable. During the global financial crisis, financial service companies with lower number of independent directors on their RMC were found to exhibit weaker performance than others with more independent directors. Hence, the presence of independent directors on the RMC could promote improved value and ensure the stability of banks [67]. In a 2014 study by the International Monetary Fund (IMF) with samples from multiple countries, it reports that independent directors have negative relationship with risk taking in banks [36]. Therefore, banks with more independent members seem to experience less risk and better performance. It suggests that there is likelihood that banks with independent directors on the RMC would be more stable in that they seem to have monitoring advantage over the management.

3. Proposed Theoretical Framework

The theories proposed for this study are the agency and resource dependence theories. Agency theory suggests that the board of directors could serve as a device for the control of management with the aim of reducing the agency problems between the managers and owners [26,30]. In performing this function, the board sets up committees which includes the RMC. Thus, the RMC supports the board in its oversight to reduce agency costs and ensure the alignment of bank owners with the management [25, 26]. The resource dependence theory, on the other hand focused on the availability of necessary resources for the functioning of the board [34,52]. These resources include the diversity of board members, their expertise, experience and education. Thus, the theory is relevant in discussing the diversity of the RMC.

Figure 1 shows the proposed framework which depicts the relationship between the risk management committee and bank stability. It indicates that the risk management committee has direct relationship with bank stability. This suggests that the committee has the potential to influence the stability of banks. The RMC is one of the important committees of the board recommended by the Basel Committee on Bank Supervision for the control of bank risk in order to ensure stability of banks. Prior studies argued that adequate attention has not been paid to the investigation of the RMC particularly, the role of the audit committee [60]. This suggests the need for further studies on the attributes of the RMC especially in relation to bank stability [38, 61]. This study aims to test this relationship.

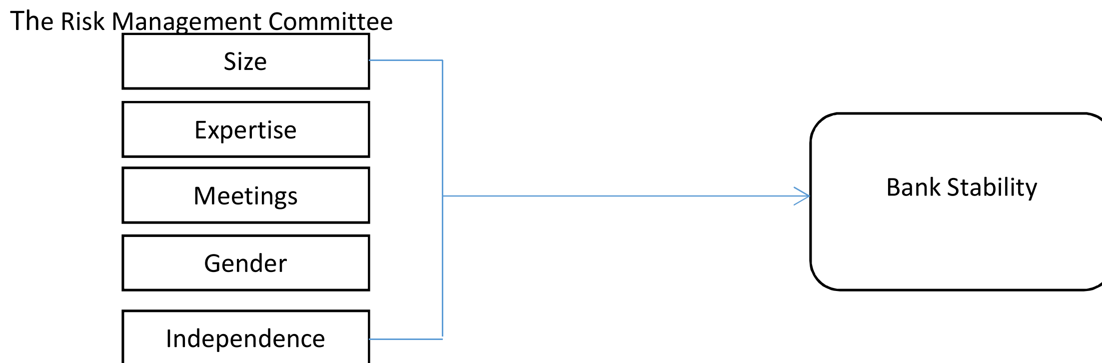

Fig. 1. The Conceptual Framework

4. Conclusion

This is a proposed research on the relationship between the risk management committee and bank stability in Nigeria. When the study is implemented, it is expected to provide empirical evidence on the relationship between the RMC and bank stability in Nigeria. The outcome is to yield policy suggestions on how to improve the stability of the Nigerian banking system. It is expected to reveal the extent to which the RMC could enhance the stability of banks and to further show if there are steps that could be taken to aid the effectiveness of the RMC in banks. Bank stability is fundamental to economic stability. If banks are unstable, nations will face unpredictable economic conditions with severe implications for growth, employment and overall development. However, if board committees such as the RMC functions well, they could contribute to risk reduction which is usually at the root of most instability in banks. The outcome of the study is expected to be useful for reforms of the RMC and to aid policy formulation on risk governance in banks.

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