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RISK MANAGEMENT COMMITTEE ATTRIBUTES AND BANK PERFORMANCE IN NIGERIA

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Abstract

A dearth of research exists in bank corporate governance via the risk-management related governance variables in Nigeria. This study was therefore conducted to examine the impact of risk management committee on performance of deposit money banks in Nigeria from 2007 to 2015. Data were collected from a sample of 15 banks listed on the Nigerian stock exchange (NSE). The analysis was done with the use of multiple regression technique. The study found that all the risk governance variables, except the risk committee size, are positively related to return on asset and return on equity as indicators of bank performance, at 5% level of significance. The study concluded that risk governance has positive and significant effect on the performance of deposit money banks in Nigeria. Therefore, the study recommends that the members of risk committee be properly motivated, meet more frequently, include more independent directors, and more financial and risk experts, as all these will lead to better performance of the banks.

Keywords: Risk, governance, bank, performance, risk committee, Nigeria

1. INTRODUCTION

Strengthening financial systems especially the banking sector has always remained a central issue facing developing economies. This is because of the theoretical argument that sound financial and banking systems promote economic growth. For this reason, Nigeria, like other countries of the world, has adopted different reform measures at macroeconomic level aimed at attaining sound banking and financial systems. One good example of these reforms is the bank consolidation and recapitalisation exercise of 2004 which increased the bank capital base from ₦2 billion to ₦25 billion. More so, the number of banks was initially reduced from 89 to 25 stronger banks with higher level of sophistication. As at the end of 2015, there are 19 deposit money banks in the country out of which 15 are listed on the Nigeria stock exchange (NSE). With the success of the exercise, deposit money banks performances were expected to improve continually for the foreseeable future, so also their contribution to the nation's economy.

Unfortunately, the story was different with the experience of the global economic and financial crises of 2007-2009 and its aftermath effect on the Nigeria banking sector. The lesson learnt from the crisis was that reform efforts should have paid more attention not only

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to the external microeconomic environment but also the internal governance of the institutions. This is because the safety and soundness of banks and other financial institutions rely heavily on the effectiveness of the directors' oversight function technically known as the corporate governance. Good corporate governance helps in strengthening financial system and a strengthened system is crucial to economic growth (Levine, Loayza & Beck, 1999).

The recent financial crisis confirms risk as the major business of banks and the need for best practices in the governance of risk. Best practices in risk governance as an aspect of bank corporate governance outline the need for a dedicated board-level risk committee of which a majority should be independent (Mongiardino & Plath, 2010). With proper risk governance, strategies will be formulated and informed decision will be taken to reduce the overall risk of banks which will ultimately boost performance. Recognising the significance of risk governance in bank, the Central Bank of Nigeria (CBN) code of corporate governance for banks in Nigeria post consolidation provided for board risk management committee. The CBN's main objective in this regard was to ensure that sound risk governance exists in banks which will improve banks' performance (CBN, 2006).

However, the effectiveness of the code in enhancing risk governance in banks was tested by the recent global financial crisis which extended to the Nigerian banking sector. The banking crisis had since been linked to some factors including failure in corporate governance in banks. Corporate governance in many banks failed because their boards ignored best practices and some factors such as lack of board independence and ineffectiveness of board committees (CBN, 2009). Pointing to the peculiarity of the board risk management committee, Sanusi (2012) observed that some board committees were ineffective and dormant in discharging their responsibilities. For this reason, some banks performed worse than the others during the crisis. It was in this light that many research works (Sanda, Mikalu & Garba 2005; Kajola 2008; Babatunde & Olaniran, 2009; Semiu & Temitope, 2010; Abogun, Fagbemi & Balogun, 2012) have been conducted on corporate governance and bank performance in Nigeria. Most of these studies however failed to consider risk governance variables. It therefore becomes imperative to critically look at the risk management related corporate governance mechanisms and variables such as the risk committee, frequency of the risk committee meetings, independence of the board committee, financial and risk expertise of the committee members and their effects on the performance of deposit money banks in Nigeria.

2. LITERATURE REVIEW

Risk governance is relatively new in the corporate governance arena and as such has no consensus definition. According to International Finance Corporation [IFC] (2012) risk governance in business firms has to do with the manner and ways in which a firm's risk taking activities are authorised, optimised and monitored by the directors. It involves all the structures, skills, controls and information deployed by the directors to perform their oversight function in risk management. Risk governance represents the architecture within which risk management operates in a company, and defines the way in which a company carries out its risk management functions (Corporate Governance Council, 2012). The Council stated further that since it is essential for the company to be clear about what and how risks are being managed, risk governance serves as a guide for sound and informed decision making in this regard and even in effective resources allocation. Capuano (2013) cited in Cavezzali and Gardenal (2015) views risk governance as the activity performed by the board and the management of the company relating to controlling risks and designing of

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internal control systems for the identification, measurement and management of risk. Risk governance has also been viewed as risk management-related corporate governance with mechanisms such as board risk committee, appointment of a chief risk officer and creation of reporting line for the risk officer in order to ensure that the risk oversight function of the board is effectively carried out (Aebi, Sabato & Schmid, 2012).

Risk governance plays a significant role in making companies more resilient, enhancing transparency of their operations and protecting the interests of their shareholders. It is a fundamental business practice that business firms must get right as it sets the framework to navigate uncertainty in the environment in which they operate (KPMG, 2014). Due to this importance, good risk governance is essential for effective functioning of the firm and what make risk governance good are clearly defined authority, accountability and communication or reporting mechanisms (IFC, 2012).

2.1 Conceptual Issues

2.1.1 The Risk Committee of the Board and its Attributes

Sound risk governance enables the company to assess its risk tolerance, and design processes of risk management in relation to reasonable expectations of stakeholders. A separate board risk committee is usually put in place to assist the board in its risk governance responsibility. Generally, having a risk committee is an indication that a stronger risk management and thus better risk governance is in place. The International Finance Corporation [IFC] (2012) stated that in any financial institution, the board may choose to perform its risk oversight responsibilities through a dedicated group of its members, and the group will be known as the board risk committee. According to Arioglu and Tuan (2014) the risk committee is expected to be responsible for the determination of risk tolerance level of the bank. Determination of risk tolerance level became an important risk topic following the experience of the global financial crisis (Arioglu & Tuan, 2014). It can of course be argued that one of the major reasons for the crises was the failure of the boards to identify potential risks (Walker, 2009).

IFC (2012) summarised the responsibilities of a risk committee of bank or any financial firm to include making recommendations regarding risk appetite, reviewing periodically the company's risk profile, reviewing periodically the risk management and internal controls framework relative to risk profile, approving risk policies, limits and delegations, considering any key risk issues brought by management, and reviewing and recommending for board approval key policy statements required by the regulators such as those on large exposures, liquidity, credit impairment and provisioning. To carry out these responsibilities, risk committee members should be knowledgeable about risk governance and business activities of the firm for them to be able to challenge the board or management decisions.

The size of the board risk committee is one of the risk governance variables whose effect on the bank performance needs empirical evaluation. According to Battaglia and Gallo (2015), banks with large number of directors in the risk committee perform better in terms of profitability. This may be related to the influence of the size of the committee on the board decision making concerning risk oversight function. In relation to the members' experience, the board risk committee requires members that who can understand and assess the risks faced by the firm. According to Yatim (2009), risk management committee with expert members will be in a better position to monitor the risks and risk management policies and

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procedure due to their background and experience. The committee should comprise members with technical knowledge on the operations and products of the bank (Kallamu, 2015). Unfortunately, many large banks even in the advanced countries, have dedicated risk committees, whose memberships did not comprise of enough financially knowledgeable members (Hau & Thum, 2009). The reason for this could be attributed to a research report (Solange, 2015) that risk management expertise is scarce and it remains a serious challenge for banks to find people with the right skills to oversee risk management. Cavezzali and Gardenal (2015) stated that the number of meetings of risk committee has negative influence on the performance of banks. This was however in contrast to Aebi, *et al.* (2012). In a nutshell, the effectiveness of this committee may however depends on the size of the committee, the committee independence, and frequency of their meeting, content, quality and accuracy of the committee reports submitted to the board.

2.1.2 Measuring Bank Performance

Studies have identified profitability, liquidity and asset qualities as some of indicators used in measuring banking performance (Kumbrai & Webb, 2010). Performance of bank has also been measured from angles like growth in asset, number of branches, deposit base, lending, and number of employees (Uddin & Bristy, 2014). Therefore bank performance are measured with different indicators, but according to Uddin and Bristy (2014), the most commonly used performance indicator for any organisation including bank, is its profitability. High profitability indicates better performance while poor performance is indicated by low profitability. Besides, shareholders view performance as profit made on their behalf by the management. Profit is the ultimate result or output of a business firm and the business will have no future if it fails to make sufficient profits (Ben, *et al.*, 2015). Relating governance to bank performance in Nigeria, Sanusi (2012) agreed that effective corporate and risk governance in banks is related to bank performance in terms of profitability. In this study, the concept of performance is operationalised to mean profitability of the banks and return on equity (ROE) was used as performance index. Conceptualising bank performance as profitability implies that risk governance variables are expected to exert some influence on the profitability of deposit money banks.

2.2 Theoretical background

The study is conducted within the framework of agency theory. Agency theory is credited to Jensen and Meckling (1976) who described agency relationship as a contract in which one party (the principal) engages another party (the agent) to perform certain services on behalf of the principal. For the agent to be able to perform its duties under the contract, the principal delegates some decision-making authority to the agent (McColgan, 2001).

Arising out of the agency contract is the conflicts of interest as the agent is not likely to always act in the interest of the principal; leading to some agency problems. To curtail the problem, some agency costs will have to be incurred. According to Aguilera, Filatotchev, Gospel and Jackson (2008), the conflict of interest between the shareholders and the management is created by the separation of ownership and control of the firm. Any activities pursued by the management and which are detrimental to the interest of the shareholders of the company creates agency problem (Kasum, Etudiaye-Muthar, Oyebola & Abdurrasheed, 2011). The theory has been validated by many studies including the recent works like that of Nasieku, Olubunmi, and Togun (2014) which concluded that ensuring good performance of the firm by putting necessary governance structure in place is rooted to in agency theory.

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Leung and Ilsever (2013) also supported the validity of the theory by stating that corporate governance mechanisms are important factors necessary for mitigating agency costs.

Relating the agency theory to this study calls for the understanding of the importance of risk committee of the board in resolving the conflict of interest between the shareholders and the managers. This conflict resolution is expected to reduce agency cost for banks. According to Klein (1998), board performs better when functions are delegated to committees such as that of risk management functions. In fact, having such committees of the board is more pronounced in companies with high risk and agency cost (Kallamu, Saat & Senik, 2013). The importance of risk committee was also buttressed in Laux and Laux (2009) that information asymmetry is reduced when directors perform their monitoring functions through directors on board committees. Risk management committee performs a very important function in the monitoring of the risk and internal control in finance companies (Ng, Chong & Ismail, 2013). The role plays by this committee ensures that the conflict of interest between the shareholders (with a diversified portfolio who may not be concerned much about risk) and the managers who are risk averse is managed through monitoring by the board (Tao & Hutchinson, 2012). This will thus ensure that managers do not avoid profitable but risky projects that may enhance shareholder value (Kallamu, 2015).

2.3 Empirical Review

Battaglia and Gallo (2015) found positive and significant relationships between the risk governance variables and bank performance of 36 banks in China and India. This was in line with Kallamu *et al.* (2013) which analysed the moderating effect of risk management committee on the performance of listed finance firms in Malaysia. The study found that having a risk management committee positively affect the firm performance indicated by ROA and Tobin's Q. Concerning financial expertise and experience of directors in the risk committee, Adams and Jiang (2014) examined the relationship between board-level financial experts and earnings-related performance indicators of ninety two insurance firms in UK for a 14 years period from 1992 to 2012. It was concluded that collectively, financial expertise of directors has positive and significant impact on performance. A contrary finding was reported by Kallamu (2015) on the relationship between risk management committees' expertise and prior experience of the directors in the committee, and corporate performance of finance companies in Malaysia. The result obtained indicates that finance expertise of directors on risk committee has a negative relationship with ROA, though the relationship was not significant.

Aebi *et al.* (2012) investigated the relationship between risk management-related corporate governance mechanisms and a better bank performance during the financial crisis of 2007/2008. Multivariate regression analysis was employed to analyse the data. Result of their analysis shows that risk committee is negatively related to bank performance during the crisis and the relationship is statistically significant. It was however reported that the number of meetings of the risk committee is positive and significant. In Italy, Cavezzali and Gardenal (2015) conducted an empirical analysis of 21 Italian banks from 2005 to 2013 to ascertain whether risk governance practices affect level of risk and bank's performance. The study found that risk committee experience and other governance variables have no significant effect on either the risk level of the company or the level of bank performance. In a recent study, Kallamu (2015) investigated the impact on risk management committee attributes on firm performance for a sample of thirty seven finance companies in Malaysia over a five-year period from 2007 to 2011. Multiple regression analysis was used to analyse the data and the

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result showed a significantly negative relationship between independence of risk committee and ROA as a performance measure. The finding of Kallamu (2015) was at odds with Minton, Taillard and Williamson (2011) who found that board independence is associated with lower risks, which therefore enhance bank performance.

In Nigeria, most of the studies conducted in the area of bank governance were restricted by the use of the standard corporate governance variables. That is, no particular focus is given the identified risk governance variables. For example, Sanda, Mikalu and Garba (2005) studied the effect of corporate governance mechanisms on banks financial performance in Nigeria. Three variables board composition, board size and power separation between chairman and CEO were used to proxy corporate governance and performance was measured with ROE, sales growth and Tobin's Q. The result of the study indicates a positive and significant impact of corporate governance on ROE and Tobin's Q. Other studies like Akpan and Rimon (2012) Kwanbo and Abdul-Qadir (2013), Ihemeje, Okerefor, Ogungbangbe and Edeoga (2015) Isaac and Nkemdilim (2016) failed to consider risk governance variables.

3. METHODOLOGY

Pooled data analysis was conducted with Ordinary Least Squared (OLS) regression technique. However, the predictive power of the pooled OLS could not be relied upon due to the fact that each bank as a cross-sectional unit might possess some special characteristics of its own which could affect the overall result of the regression analysis. To resolve this possibility, Hausman test was carried out to choose between fixed effect (FEM) or random effect (REM) models. According to Gujarati (2004), the null hypothesis underlying the Hausman test is that the FEM and REM estimators do not differ substantially; and that if this hypothesis is rejected, then REM is not appropriate and thus FEM is adopted. Random effect model was eventually used for this study based on the result obtained from the Hausman test.

4. RESULT AND FINDINGS

Result of panel regression analysis was presented and interpreted in section. Analysis of the regression was made after some preliminary tests such as multicollinearity and Hausman tests have been carried out.

4.1 Multicollinearity Test

Table 1: Pair-wise Correlation

	RCS	RCM	RCIND	RCEXP	BOIND	BS
RCS	1.000000	0.257796	-0.250862	-0.150877	0.114224	0.205882
RCM	0.257796	1.000000	0.080186	0.197185	0.210050	0.423837
RCIND	-0.250862	0.080186	1.000000	0.180207	-0.287868	-0.062482
RCEXP	-0.150877	0.197185	0.180207	1.000000	0.161430	0.432859
BOIND	0.114224	0.210050	-0.287868	0.161430	1.000000	0.451830
BS	0.205882	0.423837	-0.062482	0.432859	0.451830	1.000000

Source: Author's computation (2017)

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Table 1 shows the pair-wise correlation values for the explanatory variables. The values explain the possibility of having perfect linear relationship between any pair of two independent variables. This is because ordinary least square regression technique assumes the absence of multicollinearity among the independent variables if a higher level of accuracy is to be expected from the estimation. Applying a multicollinearity plagued regression for forecasting will be too hazardous. It is clear from the above table that there is no perfect relationship between the different pairs of independent variables. That is, there is no multicollinearity as no single values in the table is in the region identified by researchers and econometricians as multicollinearity headache. Gujarati (2004) asserts that multicollinearity becomes a serious issue whenever the correlation coefficient between two regressors is above 0.8.

Table 2: Hausman Test

Model	Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
ROE	Cross-section random	3.719021	6	0.7146

Source: Author's computation (2017)

The above table 3 indicates that no significant difference exists between the fixed effect and random for the models as p-value in each is greater than 0.05. This implies random effect model is preferred for the analysis as the null hypothesis was accepted. From this test, the regression analysis and hypotheses testing were made using the random effect model estimator.

Table 3: Risk committee attributes and Return on Equity (ROE)

ROE	Coefficient	Std. Error	t-statistics	Prob.
Constant	112.1891	100.3281	1.118222	0.2656
RCS	-5.311061	3.442664	-1.542719	0.1253
RCM	1.125193	0.548055	2.053066	0.0413
RCIND	0.560234	0.234122	2.392914	0.0180
RCEXP	3.341039	1.191277	2.804614	0.0057
R-Squared	0.728524			
Adjusted R ²	0.621240			
DW stat	2.189608			
F-statistic	11.704932			
Prob(F-statistic)	0.000328			

Source: Author's computation (2017)

From the above table 3, Durbin-Watson statistic of 2.19 means there is no autocorrelation. That is ROE is not affected by its recent past history and thus consistent with the assumption of the classical regression analysis.

The size of the risk committee (RCS) is negatively related to ROE. This may linked to the extra cost attached to any increase in the size. The effect was however not significant as

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indicated by p-value of 0.1253 at 5% level of significance. It was not significant even at 10% level of significance. The insignificant negative relationship was also reported by the t-statistic of -1.54 as shown in table 3 above. As for the risk committee's meeting, there exists a significantly positive relationship between the frequency of risk committee's meetings (RCM) and ROE of banks. The effect of RCM on ROE is positive and significance at both 5% and 10% significant levels. P-value of 0.04 and t-statistic of 2.05 as reported in the table buttressed this fact. Also, risk committee independence (RCIND) is found to be positively and significantly related to the ROE. RCIND has a significant effect on ROE as supported by the p-value of 0.0180 and t-statistic of 2.39.

Risk management expertise of the risk committee members is another importance variable that influences the ROE of banks. The table shows that the variable has positive and significant effect on ROE. The finding is significant with p-value of 0.0057 and t-statistic of 2.80 at 5% and 10% levels of significance. R-squared of 0.73 indicate the fitness of the model. The implication of the R^2 is that 73% of the variations in the dependent variable (ROE) were explained by the independent variables (risk governance variables). Probability of F-statistic (0.0003) indicates the overall significance of the model.

5. CONCLUSION AND RECOMMENDATIONS

The study deemed it fit to assess the effect of risk governance in terms risk committee attributes on bank performance in Nigeria for appropriate policy recommendations. From the findings of the study, it was concluded that performance of deposit money banks in Nigeria is enhanced by deliberations of the risk committee through series of meetings, independence of the committee, and risk expertise of the committee members.

Based on the findings of the study and the conclusion drawn, the study recommends that the CBN, as the regulator for banks in Nigeria should allow some level of flexibility in the number of meetings hold by banks' boards and their risk committees; as this will give room for meetings to be held as risk taking issues arise. Also, the Code of corporate governance for banks should be revised to provide for more independent directors on the boards of the banks and consequently on the risk committees of the boards.

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