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The Influence of Risk Management Committee Characteristics on Bank Asset Quality

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Abstract:
Strengthening the banking sector has remained a critical issue in most financial markets. Therefore, in this paper, a review on the influence of bank risk management committee (RMC) characteristics on bank asset quality (BAQ), measured as the ratio of banks non-performing loans (NPLs) was conducted. To achieve the objective of the study, a review of prior literature that have examined series of RMC characteristics on several corporate outcomes was considered. Based on the review, it was found that certain characteristics of the RMC may improve the risk governance of banks. These characteristics include the RMC independence, RMC size, RMC meetings, RMC gender, RMC expertise, presence of CEO on the RMC, RMC chair-gender and RMC chair-independence. Thus, future studies can examine whether the RMC characteristics play any significant role towards reduction of non-performing loans of Nigerian banks, thereby improving banks assets quality. Investigating this issue is necessary because sound financial system promotes economic growth.

Keywords: *Corporate governance, bank asset quality, NPL, risk management committee*

1. Introduction

Agency theory suggests there are conflicting risk preferences for shareholders and managers that are risk-averse which imposes board monitoring (Jensen & Meckling, 1976). Therefore, without effective monitoring, profitable riskier projects may be rejected by risk-averse managers which are so attractive to the company shareholders that chooses returns increase from high risk level. Excessive risk-taking by those in the managerial positions is considered very problematic in the financial industry (banks) because the failure of one bank will lead to the collapse of another in the same direction. Pathan (2009), proposes that shareholders from the banking industry wish to take extreme risk due to the problem of moral hazard particularly in limited liability and the related bailouts. Consequently, excessive risk-taking monitoring from management is important particularly in the financial industry. The risk management committee is responsible for the oversight and monitoring of banks' related activities of risk. Thus, a risk committee that condenses high risk-taking and failure probability of a systemically imperative bank will benefit the bank shareholders. This paper reviews literature on the important of banks risk management committee (RMC) and bank asset quality (BAQ). The study suggests that a number of committee characteristics like (size, composition, expertise, gender, meetings and other functions) can influence bank activities and ensure that their activities are aligned with the interests of shareholders. Similarly, banks experiencing increasing levels of risk require RMC that can monitor and manage risk. As such, the RMC characteristics may have a vital role to play in the banks' risk levels. On this note, this study contributes to the literature in several ways. First, there is little research on the board committees in Nigerian banks and their effect in particular on NPL. Secondly, many financial institutions (banks in particular) have been criticised widely for excessive bonuses payments to some senior management and executives especially during global financial crisis, which thought to be the outcomes of reckless risk-taking by banks (Pathan, 2009). The remaining section of the article is as follows: section 2 captures the review of related literature and propositions, section 3 describes the research method and section 4 presents the conclusion of the study.

2. Literature Review

2.1. Risk Management Committee Size and BAQ

Extant studies contend that higher managerial monitoring is more associated with large boardrooms, which positively influenced BAQ and reduced the level of NPL(de Andres & Vallelado, 2008; Grove et al., 2011; Lu & Boateng, 2018; Wang & Hsu, 2013). Felo et al. (2003), report a positive association between size of the board sub-committee and quality of financial reporting. Coles et al. (2008), filed that the influence of board size is highly pronounced for large and more diversified companies and companies that highly rely on debt financing. Guest (2009) proposes that the legal and institutional environment also clarifies the board size effectiveness. Ng et al. (2013) find a significant negative association between RMC size and risk. Implying that larger committees are more resourceful in addressing numerous risk related issues and thus making it very effective in monitoring risk taking. However, Tao and Hutchinson (2013) do not find such an association with respect to RMC and risk. This research claims that a large RMC, in the incidence of high NPL ratios, may play a role of monitoring that is more effective to ensure all risk-related decisions that may deteriorate BAQ are properly addressed. Therefore, the more the monitoring abilities of directors in a large RMC the greater the likelihood to enhance the BAQ. Hence, we propose that:

- P_1: There is negative association between RMC size and NPL

Authors	Context/ Period	Methods	Key Findings	Measurements	DV
Ng et al. (2013)	Malaysia (2003-2011)	Panel OLS regressions	Negative Significant	The proportion of losses incurred to premiums earned.	Underwriting Risk
Tao and Hutchinson (2013)	Australia (2006-2008)	GLS, 2SLS regressions	Negative Insignificant	BETA and $LNEPS_{t+1}$	Risk and Performance
Ibrahim (2020)	Sub-Sahara Africa (2010 – 2016)	GLS, 2SLS regressions	Negative Insignificant	NPL	Intellectual Capital Efficiency
Al-Hadi et al. (2016)	GGC (2007-2011)	OLS regression	Positive Significant	Market risk exposures disclosed	Market Risk Disclosure
Aldhamari et al. (2020)	Malaysia (2004-2018)	PCA	Positive (Negative) Significant	ROA, Tobins Q	ROA, Tobins Q

Table 1: Summary of Literature on Risk Management Committee Size

2.2. Risk Management Committee Independence and BAQ

The RMC is responsible for monitoring the risk level in which the bank is exposed to while keeping in mind the need to maximizeits returns (Pathan, 2009). The RMC advises the board on current and future risk exposure and strategies on bank's management (Walker, 2009). However, the effectiveness of the RMC in monitoring and identifying excessive risk-taking hinge on the composition of members of the committee which, in turn, leads to better performance (Tao & Hutchinson, 2013). The RMC is characterized as a mechanism for risk governance that manages the banks' risk appetite, hold the risks and communicate the risks more effectively to diverse stakeholders. Aebi et al. (2012) argued that the risk management committees may ultimately indicate a strong risk management monitoring that will improve the oversight function of CG.

The RMC independence entails the use of the experience of the individual members to provide policy guidance through the direction of the top management in the context of going-concern and all financial/non-financial transactions of a business (Persons, 2009). There is this belief that a larger proportion of independent external directors would be compelled to control and monitor the activities of executive so their conduct would be neutralized in achieving an unfair self-serving (Goddard & Masters, 2000). In addition, Akhtaruddin and Haron (2010) indicate that a board committee with majority independent directors appears to face less management disruption when it comes to the question of independence, which is necessary by law to increase the effectiveness of such a committee. Independence of the committee leads to higher quality financial statements and reduced the cost of agency. Tao and Hutchinson (2013), support this claim, stating that the independent directors' proportion in RMC reduces asymmetry information problem. Table 2, presents the studies on RMC independence.

Authors	Context/ Period	Methods	Key Findings	Measurements	DV
Dong et al. (2014)	China (2003-2011)	OLS regressions	Negative	NPLR/TL	NPL
Ng et al. (2013)	Malaysia (2003-2011)	Panel OLS regressions	Negative	The proportion of losses incurred to premiums earned.	Underwriting Risk
Tao and Hutchinson (2013)	Australia (2006-2008)	GLS, 2SLS regressions	Positive	BETA and $LNEPS_{t+1}$	Risk and Performance
Yeh et al. (2011)	G8 countries (2005-2008)	OLS regression	Negative	Ratio of net income to total assets	Excessive Risk-Taking
Sharon et al. (2015)	Nigeria (2005-2009)	OLS panel data analysis	Negative insignificant	Non-performing loans to total loans	NPL, LLP
Al-Hadi et al. (2016)	GGC (2007-2011)	OLS regression	Positive insignificant	Market risk exposures disclosed	Market Risk Disclosure
Aldhamari et al. (2020)	Malaysia (2004-2018)	PCA	Positive Significant	ROA, Tobins Q	ROA, Tobins Q

Table 2: Summary of Literature on Risk Management Committee Independence

Extract from table 2, shows that the independent of RMC has a negative influence on bank risk-taking. For example, Dong et al. (2014),look at the association between ownership structure and Chinese banks risk-taking reported that the independent RMC has a negative and significant influence on BAQ, signifying that RMC independence helps in improving bank risk management and reduces their level of NPL. In the same vein, Ng et al. (2013), examine RMC independence of insurance companies and report a significant negative association between RMC independence and risk-taking. However, Tao and Hutchinson (2013), find that RMC independence is positively associated with risk. Such an association is open to the criticisms of end ogeneity of the variables because the committee composition can affect the company performance, and the company performance can, in turn, affect the committee existence. Instead, the study holds that, the positive association between risk and performance depends on the committee composition. This means, the committee composition moderates the negative association between excessive risk and performance. On the overall, these results suggest that, a strong and independent RMC could be an ultimate instrument of curtailing risk exposures especially regarding NPL ratios in banks which eventually enhance the BAQ. Thus, the research forms the following proposition:

- P_2: There is negative association between RMC independence and NPL.

2.3. Risk Management Committee Expertise and BAQ

The nature of NPL risk exposures makes it not easily understand able by directors that lack relevant experience and qualifications. A director that is financially literate onRMC is expected to detect any misguided initiative by management that may leads to the rising NPL ratio and take decisions that are prudent. An efficient and effective RMC should thus consist of some members that are professionally qualified in order to ensure better asset quality for the bank. However, the CBN Code of CG (2006),emphasizes for the need for professionally qualified financial expert directors, which is observed as one of the major barriers to the board effectiveness of banks in Nigeria.

The resource dependence theory proposes that a well-qualified board member can help to link the company with the external environment and thereby obtain other valuable resources for the company(Pfeffer& Salancik, 2003). Likewise, agency theory specifies that boards that are well-qualified improve their monitoring ability on management(Cabedo & Tirado, 2004) and thus put more effort in enhancing the interest of stakeholders. Similarly, Lee and Stone (1997),suggest that a board member in the sub-committee should at least have the relevant qualifications and experience to take over their monitoring functions efficiently. Likewise, Dhaliwal et al. (2010),and Agrawal and Chadha (2005),claim that financial expertise directors can exercise more monitoring that is very effective in the process of financial disclosure. Al-Hadi et al. (2016), also report a positive significant association between RMC qualification with risk which is consistent with the opinion that highly qualified board understand and apply the principles of accounting standards and far better in risk management process. Additionally, Ibrahim (2020),find a significant negative association between financial expertise of the RMC and credit risk measured by NPL. Consistent with the above results, this study then posits that, if members of the RM Care well qualified with financial knowledge, they can expand the ability of the RMC to ensure better BAQ. Thus, the following proposition is formed:

- P_3:There is negative association between RMC expertise and NPL.

Authors	Context/ Period	Methods	Key Findings	Measurements	DV
Ibrahim (2020)	Sub-SaharaAfrica (2010 – 2016)	GLS, 2SLS regressions	Negative Significant	NPL	Intellectual Capital Efficiency
Al-Hadi et al. (2016)	GGC (2007-2011)	OLS regression	Positive Significant	Market risk exposures disclosed	Market Risk Disclosure
Aldhamari et al. (2020)	Malaysia (2004-2018)	PCA	Positive Significant	ROA, Tobins Q	ROA, Tobins Q

Table 3: Summary of Literature on Risk Management Committee Expertise

2.4. Risk Management Committee Meetings and BAQ

Meeting offers a good chance for members of the RMC to openly discuss, communicate, and accomplish a common goal in monitoring risk and fraud control. Sori et al. (2009), specified that the frequency of meetings indicates the amount of energy exerted by the committee members to accomplish the entrusted responsibilities. It as well indicates the times devoted by the members of the committee to rectify harsh conditions suffered by the company(Abdul Rahman & Ali, 2006).Several studies have shown that the meetings frequency plays a vital part in determining the committee's effectiveness. For instance, Abbott and Parker (2000),reports that the meeting frequency ofAC indicates the members desire to accomplish their responsibilities; thus have negative association with fraud. The general belief is that regular meetings warrant a smooth and more effective as well as efficient process of monitoring. However, Ng et al. (2013), document that the meetings frequency of RMC do not offer any quality discussions hence find negative but insignificant association between RMC meetings and risk-taking. Similarly, Ibrahim (2020), find positive and significant association between RMC meetings and NPL hence it lent no support to the previous hypothesis that meeting frequently reduces bank NPL. Conclusively, RMC that meets frequently enable it members to be current in managing activities regarding risks through constant appraisal. Hence, it is proposed that:

- P_4: There is negative association between RMC meetings and NPL

Authors	Context/ Period	Methods	Key Findings	Measurements	DV
Ng et al. (2013)	Malaysia (2003-2011)	Panel OLS regressions	Negative Insignificant	The proportion of losses incurred to premiums earned.	Underwriting Risk
Ibrahim (2020)	Sub-Sahara Africa (2010 – 2016)	GLS, 2SLS regressions	Positive Significant	NPL	Intellectual Capital Efficiency
Tao and Hutchinson (2013)	Australia (2006-2008)	GLS, 2SLS regressions	Positive Significant	BETA and $LNEPS_{t+1}$	Risk and Performance
Aldhamari et al. (2020)	Malaysia (2004-2018)	PCA	Positive (Negative) Significant	ROA, Tobins Q	ROA, Tobins Q

Table 4: Summary of Literature on Risk Management Committee Meetings

2.5. Risk Management Committee Gender and BAQ

Bilimoria and Piderit (1994) document that existing studies shows the delegation of CG to board of directors' committees enables effective board of directors and corporate roles. Bilimoria and Piderit further explain that committees of the board of directors provide an avenue through which effective governance is structured by facilitating distinct tasks that are very vital for the corporate concerns. Jiraporn et al. (2009), claim that effectiveness of the board of directors is entirely accomplished with the help of board committees. Usman et al. (2018), submit that independent female directors on board committee have a significant influence on the association between CEO pay and company performance, implying that the monitoring influence over shadows the executive effect. However, if the arguments above are accurate, there is every tendency that diverse board members may have much influence through committee membership than the membership of the board alone. The idea is supported by empirical evidence that more decisions that are of good quality are merely made at committee level and those decisions influence the company performance. Adams et al. (2008), argue that the indication on audit committees supports the notion that the committee formation is associated with good quality accounting. There is shortage of direct evidence on whether board committee's composition is more imperative than the board composition regarding improved performance for the company. Therefore, any exceptional merit or demerit that might happen of a woman in relation to board process are assumed to have direct impact through board committees' assignments. This study proposes that:

- P_5: There is negative association between RMC gender and NPL

2.6. Risk Management Committee Chairperson Independence and BAQ

As a policy structure on the qualities of the board committee members, non-executive directors should be all or most members of the board committees, while an independent non-executive director should be the chairman of the committee(Chobpichien, 2008). Regarding the independence of the chairman of the board committees that previously in charge of banks' board committee functions, Spangler and Braiotta (1990), find a positive effectiveness-transformational leadership association of the board committee along with some characteristics of transactional leadership. For instance, in Malaysia, Haniffa and Cooke (2002), states that the position of the chairperson should play an important role in the board's effectiveness. Chobpichien (2008), find that having board committee chairman that is independent director increases the effectiveness of such a committee in terms of board committee performance.

In terms of business success, however, previous studies by Ahmad et al. (2016), O'Sullivan et al. (2016) and Zagorchev and Gao (2015) indicate that independent directors contribute to improving the BAQ. They recommend that independent directors have a negative association with the ratio of NPL. Their results suggest that an independent director can improve the level of BAQ by curtailing the rising NPL. In addition, board committees composed of independent directors boost the standard of transparency, according to Bryan et al. (2004). Similarly, the theory of the agency indicates that features such as independence and an independent chairperson are possible factors that affect the efficacy of the committee (Bradbury, 1990; Carson, 2002; Tao & Hutchinson, 2013). It can also be argued that having an independent committee chairman can boost the efficiency of the board committee and increase the level of BAQ. The study therefore, proposes that:

- P_6:There is negative association between RMC gender and NPL

3. Methodology

The research uses articles related to risk governance, bank performance and risk taking published in Scopus and web of science. Other articles considered are those published on Google scholar because of scanty literature on RMC related articles. Based on the reviewed articles, the proposed research framework illustrated in Figure 1is presented. The framework focuses on the influence of RMC characteristics on BAQ.

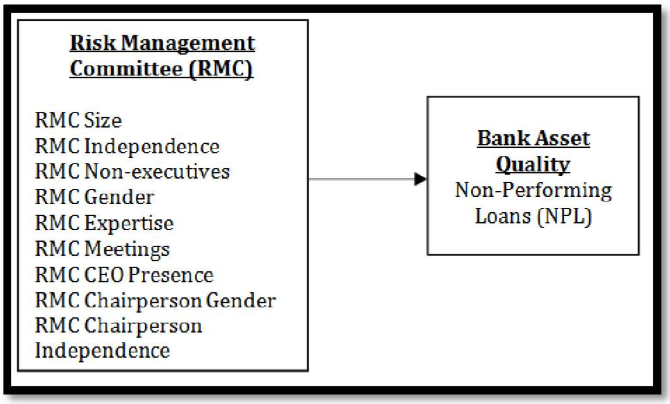

Figure 1: Proposed Framework

The BAQ is the dependent variable, measured as Non-Performing Loans (NPL). The RMC characteristics is the independent variable and it comprises variables, such as RMC Independence, RMC Size, RMC Gender, RMC Expertise, RMC Meetings, RMC CEO-Presence, RMC Chairman-Gender, and RMC Chairman-Independence. Detailed measurement of variables is presented in Table 5.

Variables	Measurement	Expected Outcome	Sources	Authors
BAQ	NPL/Gross Loans		DataStream	Castro (2013), Saif-Alyousfi et al. (2018).
RMCIND	Proportion of INED/RMC Size	(-)	Annual Reports	Ng et al. (2013).
RMCNED	Proportion of NED/RMC Size	(-)	Annual Reports	Ng et al. (2013).
RMCCEO	Dummy 1 if CEO in RMC & 0 if not	(+)	Annual Reports	Tao and Hutchinson (2013).
RMCEX	Proportion of BODs with Prof. Qual./RMC Size	(-)	Annual Reports	Tao and Hutchinson (2013).
RMCMET	No. of Meeting a Year/RMC Size	(-)	Annual Reports	Ng et al. (2013),Tao and Hutchinson (2013).
RMCSZ	No. of Directors in the RMC	(-)	Annual Reports	Ng et al. (2013).
RMCGEN	Proportion of Females/RMC Size	(-)	Annual Reports	Carter et al. (2010), Sun and Liu (2014).
RMCCG	Dummy 1 if Chair. is Female & 0 if not	(-)	Annual Reports	CBN (2014).
RMCCI	Dummy 1 if Chair is INED & 0 if not	(-)	Annual Reports	Ibrahim (2020).

Table 5: Summary of the Variables Definition, Measurement, Sources and Authors

4. Conclusion

The conclusion drawn from this study is that the banking system plays an important role in the development of a nation and as a result mechanism must be put in place to ensure that banks operate effectively. In this instance, this study argued that the characteristics of the board RMC matters. This is because extant literature had shown that the presence of RMC in banks would enable directors develop, formulate and scrutinize strategies that can mitigate the overall risk of banks, thereby limiting bank exposure to risk and possibility of bad outcomes. Therefore, it would be crucial if future studies can investigate the role played by RMC in banks governance and which of the characteristics of individuals having a board seat on committee significantly affect banks assets quality. The results from such studies may assist regulators to designing appropriate corporate governance mechanism that would make the risk governance effective. This can also help banks to improve their internal governance mechanisms leading to a sound banking system and a robust economy.

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