**International Journal of Financial Management (IJFM)**
**ISSN(P): 2319-491X; ISSN(E): 2319-4928**
**Vol. 9, Issue 5, Jul–Dec 2020; 21–34**


**International Academy of Science, Engineering and Technology**
Connecting Researchers; Nurturing Innovations

# CORPORATE GOVERNANCE AND OPERATIONAL RISK MANAGEMENT OF THE LISTED DEPOSIT MONEY BANKS (DMBS) IN NIGERIA: CONCEPTUAL FRAMEWORK

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## ABSTRACT

*Corporate governance and operational risk management in Nigerian deposit money banks are conceptualized in this paper. The aim of this research is to see how good corporate governance mechanisms can strengthen deposit money banks in Nigeria improve their operational risk management practices. Part of challenges facing deposit money banks is coping with risk and adherence to good corporate culture. Banking has seen a resurgence since the 2008 financial crises and the number of commercial banks have reduced drastically. The study will apply mixed techniques, which will aid in the exploration of qualitative and quantitative data. Corporate governance will be measured as an independent variable by board size, board composition, audit committee, and chief executive tenure, in accordance with Basel norms of corporate governance for banks. While operational risk management as dependent variable. In conclusion, risk management practices need to be supported by good corporate governance culture especially in complex industries such as banking. Without direct support and involvement from the board of directors, it is more difficult to make risk management effective.*

***KEYWORDS:*** *Corporate Governance, Operational Risk Management, Deposit Money Bank and Nigeria*

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***Article History***

***Received: 02 Dec 2020 | Revised: 03 Dec 2020 | Accepted: 05 Dec 2020***

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## INTRODUCTION

A stream of studies has shown globally that corporate governance and risk management have received great attention in financial institutions. The financial system's operation affects everyone and the economy as a whole. Banking sector is the gateway to any economy and contributes immensely to the development of the real economy (Wanke, Barros & Faria, 2015). It has enormous development potential, and in order to fulfill that potential, it is critical to take efforts to build good corporate governance and effective risk management, which will foster financial stability and allow the financial sector to evolve in a healthy manner. The health of the banking industry is strongly dependent on the state of corporate governance and risk management in an economy (Justine, 2018).

Globalization necessitated drastic changes in the banking sector across countries and opened up new avenues for ease of doing business and profit maximization. These prospects also bring with them a variety of hazards that must be managed and conquered in the process of delivering financial services and fundamental banking activities. Excessive and poorly managed risk will almost always result in losses, jeopardizing the safety of a bank's depositors. (Kenny, Jumoke & Faderera, 2014; Olukotun, Olusegun & Olorunfemi, 2013).

Corporate governance has been the topic of heated debate in the United States and around the world since the late 1970s (Crawford, 2007). The removals of Chief Executive Officers (CEOs) of companies like IBM, Kodak, and Honeywell by their boards of directors triggered the concern again. The economies of Thailand, Indonesia, South Korea, Malaysia, and the Philippines were heavily impacted by the exodus of foreign capital following the fall of massive assets during the Eastern Asian financial crisis of 1997. Huge bankruptcies and criminal misconduct by Enron and WorldCom, among other smaller companies, sparked renewed shareholder and government involvement in corporate governance in the early 2000s.Countries are putting in place various measures to ensure good corporate governance culture and sound risk management practice.

For a long time in Nigeria, good corporate governance and risk management practice have been perceived as major challenges facing Deposit Money Banks (DMBs). Board of directors are in charge of formulating policies and implementation of risk management. The boards of several banks were blamed for inefficient risk management practices before and during the financial crises (Ingley & Walt, 2008). While some CEOs set up Special Purpose Vehicles to lend money to themselves for stock price manipulation or the purchase of estates all over the world. Prior to 2014, the industry consensus was that the financial sector was healthy and that expansion should be stimulated. (Sanusi, 2010).

Because banks are exposed to a wide range of risks in their business operations, the problem has continued to have major negative effects for the industry (Nwude & Okeke, 2018).Despite a series of assessments of the Nigerian financial institutions' code of corporate governance since 2003,there have been reported cases of non-adherence by banks. For instance, on 29th of April 2021, the board of directors of First Bank of Nigeria Ltd (FBN) effected changes in executive management that led to the removal of the MD/CEO without engagement and/or prior notice to the regulatory authorities. The action by the board of FBN sends a negative signal to the market on the stability of leadership on the board and management. These problems at the bank were attributed to poor corporate governance practices and insiders who took loans in the bank, with controlling influence on the board of directors, failed to adhere to the terms for the restructuring of their credit facilities which contributed to the poor financial state of the bank.

In light of this, the apex bank (Central Bank of Nigeria) queried the board of directors on the unfortunate developments at the bank and reinstated the MD/CEO. The CBN also ordered the immediate removal of all the directors of FBN Limited and FBN Holdings Plc and appointed a new board of directors in FBN Ltd and FBN Holdings in line with its powers under BOFIA 2020. The central bank of each country enforces certain norms and regulations that all schedule banks must follow. Beyond these norms and regulations, banks must adhere to a comprehensive governance system because they serve as trustees for their stakeholders. Although, the post 2014 Code of Corporate Governance for banks seems to be more stronger than before, but without direct support and involvement from the board of directors, it is more difficult to make risk management effective Abdul Rahman et al. (2013) cited in (Ahmed, Tarek & Ehab, 2016).

There are instances of poor operational risk management in Nigeria banking sector particularly in this global era of real-time/online banking systems. The Financial Stability Report (FSR) by CBN as at December 2018 puts the total number of 1,612 complaints received from consumers of financial services between July - December 2018. This indicates an increase of 173 complaints or 12.02 per cent over the 1,439 received in the first half of 2018. Of this number, 1,602 complaints or 99.38 per cent were against banks, while 10 complaints or 0.62 per cent were against Other Financial institutions (OFIs). The complaints were in various categories, such as Excess/Unauthorized charges, Frauds, Guarantees, Dispense errors, Funds Transfers. (CBN, 2018; FSR, 2018). Furthermore, customer’s complaints against financial institutions increased by 81 percent, or 2.7 percent, from 3,051 in 2018 to 3,132 in 2019. Complaints against banks and OFIs amounted for 3,002 (95.8%) and 130 (4.2%) of the total, respectively, compared to 3,032 (99.4%) and 19 (0.6) percent in 2018. (CBN, 2019).

Also, reported cases of fraud and forgeries by banks increased to 25,029 at end-December 2018 from 20, 774 at end-June 2018. Moreover, the total amount involved stood at N18.94 billion at end- December 2018 (CBN, FSR 2019). Out of the N18.94 billion reported cases of fraud and forgeries by DMB's at end- December 2018 the following were carried out through e-channels; ATM 34.87%, Cheques 1.87%, e-Commerce 0.14%, Internet Banking 0.43%, Mobile 28.21, POS 19.55%, Web 4.99% and 8.52% was done across the counter, while 1.42% done through others. (CBN, FSR 2019).

Among other things, The Bank Verification Numbers was introduced to safeguard DMBs from exposure to both credit and operational risk, but as at December 31, 2018, the number of Bank Verification Numbers (BVNs) assigned, stood at 36,170,176 and the number of accounts linked with BVNs was 49,318,972 out of 71,214,706 active customer accounts. The unlinked accounts with BVNs can create financial risk exposure to the bank. The volume of non-performing loans increased by 13.30 percent from 281.09 billion in 2012 to N1.79 trillion as at December, 2018. (NDIC, 2019). This increase in (NPLs) is an indicator of poor credit risk management.

In order to address failures of corporate governance in the industry, the CBN reviewed the 2006 Code of Corporate Governance for banks. The new code intends to bring it up to date with contemporary realities and worldwide best practices, reduce perceived ambiguities, and improve governance methods. The Code is expected to enhance good governance practices, engender public confidence to attract investments and promote efficiency and transparency in the sub-sector (CBN, 2014). Also, the Securities and Exchange Commission (SEC) in collaboration with the Corporate Affairs Commission realized the need to align with international best practices and inaugurated a 17-member committee on June 15, 2000. The committee's mission was to identify flaws in Nigerian business practice and recommend reforms to improve it. Membership of the committee was selected from all sectors of the economy. An exposure draft code was published to elicit stakeholder input before the code was finally approved in October 2003 (Ndanusa, 2004). However, the content of the Nigerian code is similar to that of the UK's Cadbury Report, which favors the Anglo-American model (Okpara, 2009).

Furthermore, the Basel Committee on Banking Supervision, a group of Central Banks and Bank Supervisory authorities in 12 industrial countries, developed and presented the Basel I Accord in July 1988 (BCBS, 1988). The Accord was originally intended for internationally active banks in G10 countries, but more than 100 countries have adopted the Accord. The Accord relates bank capital adequacy requirements to credit risk exposure, thus reflecting the perception that credit risk poses the most serious threat to bank solvency (Olajide, 2013).

The risk identified by Basel I does not express other types of risks (market and operational) banks can be faced. Basel II addresses the gap by incorporated both market and operational risk to mitigate deposit money banks' exposure to risk. Basel II, according to the Central Bank of Nigeria (CBN), will assist secure the country's financial system. Hence, the CBN implemented the Basel II Accord beginning from December 2012 as part of measures to ensure that better risk management is adopted and maintained in the nation's banking system (CBN, 2011).

A large number of researches on corporate governance and risk management are accessible. The previous studies could not provide concrete evidence of how effective corporate governance can influence operational risk management (Flavianus, 2015; Manzaneque, Priego & Merino, 2016; Guptal et al., 2013; Bello, 2013; Chernobai et al., 2011; Moosa &

Li, 2013; Li & Moosa, 2015; Wang & Hsu, 2013; Barakat & Hussainey; Aebi et al., 2012; Willesson, 2015; Pirson & Turnbull, 2011; Faleye & Krishnan, 2010; Calomiris & Carlson, 2016). Thus, research findings in the literature could not transform effective corporate functioning that could lead to sound operational risk management. Hence misleading and inconclusive. Reviewing the current literature, this study intends to find the following major gaps:

Methodologically, the study will employ embedded mixed methods that will benefit this study in exploring qualitative and examining quantitative findings about challenges and predictors of a sound operational risk management practice in the deposit money banks. Unlike previous studies that rely heavily on secondary data derived from document analysis mainly from companies' financial reports which are usually subject to manipulations.

Most of the previous studies often uses the agency theory as a theoretical basis in explaining risk management and corporate governance (Halim, Mustika, Sari, Anugera & Mohd-Sanusi, 2017; Heide et al., 2007; Rossetti & Choi, 2008; Zsidisin & Ellram, 2003). The idea of agency is extensively used, either by itself or in combination with other ideas (Marston & Robson 1997). The signaling theory recognizes the separation of ownership and management, as well as the use of information in risk management decisions, similar to agency theory. In this regard, this study will extend and integrate both agency theory and signaling theory to explain risk management.

Contextually, in emerging countries, there are limited researches on operational risk management. While majority studies on the relationship between corporate governance and operational risk management are rare and limited to samples from affluent countries. The findings of these studies may not be applicable to African countries including Nigeria which have different regulatory and cultural environments. The current study aims to bridge this gap by exploring a first time holistic approach to develop conceptual framework for relationship between corporate governance and operational risk in the Nigeria deposit money banks (DMB).

Based on the background of this study and the facts presented above that the study attempts to explore the conceptual relationships between corporate governance and operational risk management in the Nigeria DMBs. This study is justified because operational risk is present in virtually all banking transactions and activities (CBN, 2019). Also, the study will extend the analysis of operational risk management to other explanatory factors such as corporate governance mechanisms. The study of risk management in financial institutions has been expanded to include explanatory factors such as corporate governance characteristics and ownership structure (Ahmed, Tarek & Ehab, 2016). Furthermore, the study will not only add to the scarce literature on deposit money banks' risk management procedures and corporate governance in emerging nations, but it will also be useful to all financial industry stakeholders.

## LITERATURE REVIEW

The significance of emphasizing excellent corporate governance and preventing deposit money institutions from being vulnerable to risk had subjugated finance literature and triggered scholar's curiosity in the research area. This concern will continue to be in the forefront of academic discussion as much as corporate entities continue to default. In this section, various literature and empirical studies on operational risk management and corporate governance will be reviewed. The relationships between corporate governance and risk management in financial institutions have been highlighted in the previous studies like (Amzad et al, 2019; Willesson, 2015; Calomiris & Carlson, 2016; Aebi et al., 2012; Barakat & Hussainey, 2013; Pirson & Turnbull, 2011; Faleye & Krishnan, 2010; Greuning & Bratanovic, 2003) but, there was no consensus on the outcomes of these studies.

## Operational Risk Management

Risk Management is defined as the identification, assessment and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events (Njogo, 2012). Risk implies exposure to uncertainty or threat which may adversely affect an action or expected outcome (Kaye & Lowe, 2010; Kannan & Thangavel, 2008). According to Hillson (2002), how risk is perceived has an impact on how it is handled. Excessive and poorly managed risk will almost always result in losses, jeopardizing the safety of a bank's depositors. (Kenny, Jumoke & Faderera 2014).

Operational risk has been defined as direct or indirect loss resulting from operational lapses. (First Caribbean International Bank, 2010; Bessis, 2002). Anghelache, Manole, and Soare (2016) provide a basic definition of operational risk, outline the procedures for quantifying operational risk, and provide an overview of qualitative approaches to operational risk measurement, such as the establishment of a strong internal control system. Operational risk is stated by the Basel II Capital Accord as the "risk of loss resulting from insufficient or failed internal processes, people, systems and external events or reputational risk''. This definition, unlike credit and market risk, expressly considers both external and internal events. As a result, when compared to other forms of risk, the concept of operational risk may appear to be larger and more complex (Wahlstrom, 2006).

In this vein, Mariem, Ilyes and Mohamed (2020) studied the impact of governance frameworks on the management of operational accidents in banks across the globe (United States, Australia, Canada and Germany). A total of 1176 operational loss events from 14 banks were studied using a linear model based on panel data from the 14 institutions from 2006 to 2013.The outcome shows that only six governance methods have a substantial impact on the control of operational risk. The number of independent directors on the board of directors, the number of institutional directors on the board of directors, the presence of a state representative on the board of directors, and the position of foreign directors on the board of directors are all positively and statistically significant factors in the severity of operational losses. The internal rating variable is likewise adversely and statistically associated with the degree of operational losses, according to the findings. However, turnover has little bearing on operational risk management. Because the corporate governance codes of these nations differ from those of Nigeria, this study may not be applicable.

Ahmad Bello (2013) examined the extent to which good corporate culture can mitigate Nigerian banks against exposure to risk. The research looked at data from 13 publicly traded banks from 2005 to 2009 and utilized panel data logit regression to understand corporate governance processes and risk levels. The empirical results obtained show that among corporate governance mechanisms studied; Board Composition, Audit Quality and Capitalization have significant inverse relationships with risk. Whereas, other variables in the model though not significant statistically, reveal also a negative association. The research gap identified in this study was that it was done prior to 2014 code of corporate governance and a lot of changes have taken place which might have made the findings obsolete.

## Corporate Governance

Corporate governance is a term that is both complex and multi-faceted. Scholars and experts have interpreted and described it in a variety of ways. One of the most renowned documents providing a deep insight into corporate governance is Principles of Corporate Governance released by Organization for Economic Co-operation and Development (OECD) in 1999 and reviewed in 2004. It is defined by OECD principles that “Corporate Governance involves a set of relationships between company’s management, board, shareholders and other stakeholders. It also provides the system through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined" (OECD Principles of Corporate Governance 2004). Corporate governance has been defined as a system by which companies are directed and controlled (Adrian Cadbury, 1992 & Lemo, 2010).

When used in the perspective of a business organization, corporate governance refers to a system of holding directors accountable to shareholders for effective administration of the firm in the company's and shareholders' best interests, as well as a concern for ethics and values.(Jayashree, 2006 & Mensah, 2003). From these definitions, it can be inferred that corporate governance is a structure by which organizations are managed and controlled. It targets transparency and accountability in an organization's processes with the aim of achieving responsibilities to shareholders, employees, consumers and the community it exist in.

Amzad, Farid, Normah, Norazida, and Jamaliah, (2019) investigated the managerial perceptions on interrelationship among good corporate governance, risk management, and ethical investment of the commercial banks of Bangladesh. A structured questionnaire was used to gather perceptions of managers of the sample banks. There are a total 56 banks operating across the country with 4,895 branches scheduled. The sample size for the survey was determined to be 356 respondents. The results suggest that the most important factors for effective CG were the board of directors, auditors and managers of the various departments. The study also finds that risk taking behavior of the bank is influenced by the direction of the board of directors. In this study corporate governance variables have been categorized with some sub-indices. Board's structure with independent directors and well communication with supervisors ensure the efficient risk management practices in the banks where internal audit system and transparent disclosures of the board ensure the ethical investment practices.

Mongiardino and Plath (2010) indicate that the risk governance in large banks appears to have improved only to a limited extent despite increased regulatory pressure induced by the credit crisis. They discuss best practices in banking risk governance, emphasizing the importance of having at least (1) a dedicated board-level risk committee, with (2) a majority of independent members, and (3) the CRO being a member of the bank's executive board. However, a survey of 20 significant banks reveals that only a small percentage of banks followed best practices in 2007.Despite the fact that most large banks had a dedicated risk committee, most of them convened just once or twice a year. This research was conducted outside of the United States, and more research beyond 2007 is required. The study did not employ any of the financial risk proxies to measure corporate governance characteristics.

Based on the above studies, there are several studies in the area of corporate governance and risk management. However, no research on how corporate governance can improve organizational risk management has been found in these areas. As a result, this research contributes to the field of scholarship and the body of knowledge.

## Theoretical Framework

The theoretical relationship between the two variables, corporate governance as an independent variable and operational risk management as a dependent variable, is highlighted in this theoretical framework.The corporate governance factors toward operational risk has been explained by agency theory (Eisenhardt, 1989; Kosnik, 1987; Demski & Feltham, 1978), as underpinning theory and is supported with the signaling theory (Akerlof, 1970). These theories are brought together in order to explain the influence of corporate governance on operational risk management of deposit money banks in Nigeria. Below are the detailed syntheses of the underpinning theories.

## Agency Theory

Scholars have used the agency principle in a variety of contexts. In accounting (Demski & Feltham, 1978), economics (Spence & Zeckhauser, 1971), finance (Fama, 1980), marketing (Basu, Lal, Srinivasan, & Staelin, 1985), political science (Eisenhardt, 1985, Kosnik, 1987), and sociology (Eccles, 1985, White, 1985). Economists studied risk sharing among individuals or groups in the 1960s and early 1970s (Arrow, 1971, Wilson, 1968). The risk-sharing issue, according to this literature, occurs when cooperating parties have different attitudes toward risk. This risk-sharing literature was expanded by agency theory to include the so-called agency dilemma, which arises when cooperating parties have different goals and Division of labour (Jensen & Meckling, 1976; Ross, 1973). Precisely, Agency theory is focused on the common agency relationship, in which one person (the principal) delegated work to another (the agent), who completed it. Using the metaphor of a contract, agency theory tries to explain this relationship. (Jensen & Meckling, 1976).

The aim of agency theory is to solve two problems that may arise in agency relationships. The first is the agency issue, which occurs when the principal's and agent's desires or interests clash, and second it is difficult or costly for the principal to check what the agent is actually doing. The problem here is that the principal cannot verify that the agent has behaved appropriately. The second issue is risk sharing, which occurs when the principal and agent have opposing views on risk. The issue here is that, due to differing risk preferences, the principal and the agent can prefer different behavior.

In accordance with agency theory, the present model of corporate governance comprising four dimensions as stated below is to determine risk management practice in Nigerian deposit money banks with international authorization. Outside of developing and emerging economies, the use of the agency theory about corporate governance on risk management adoption has received little attention. As a result, there is a need to investigate agency theory in developing countries like Nigeria. The aim of the research is to find out how the defined variables address the clash of interest and knowledge irregularity that arise in the middle of the principal and the agent as a result of the predetermined relationship.

## Signaling Theory

Signaling theory is useful for explaining the actions when two parties (individuals or organizations) have access to different information. In a number of management literature, including strategic management, entrepreneurship, and human resource management, signaling theory plays a prominent role.(Brian, Trevis, Duane, & Christopher, 2011). The premise of this argument is based on an information asymmetry between management (insiders) and outside investors, in which insiders have confidential information about the firm's current and future fortunes that outsiders do not.This research used signaling theory to describe how information asymmetry affects a variety of risk management actions. Because some information is private, there are information asymmetries between those who have it and others who may be able to make better decisions if they did. The fact that information signaling influences risk management theory justifies the addition of this theory.

## Conceptual Framework

A framework is established to assess the corporate governance and operational risk management of listed deposit money banks in Nigeria, based on the previous discussion and empirical evidence. According to Sekaran (2003) the research framework is the central foundation through which other research structures extend the front line of knowledge. Meanwhile, the framework if properly articulated and presented, it assists the researcher to make meaning of the findings of the study under review. It can be used to explain the possible connections and relationship between the variables of the study (Saunder, Lewis & Thorhill 2007). Hence, the proposed conceptual structure illustrates the relationship that may exist between the independent variables and dependent variables of the study as presented below.

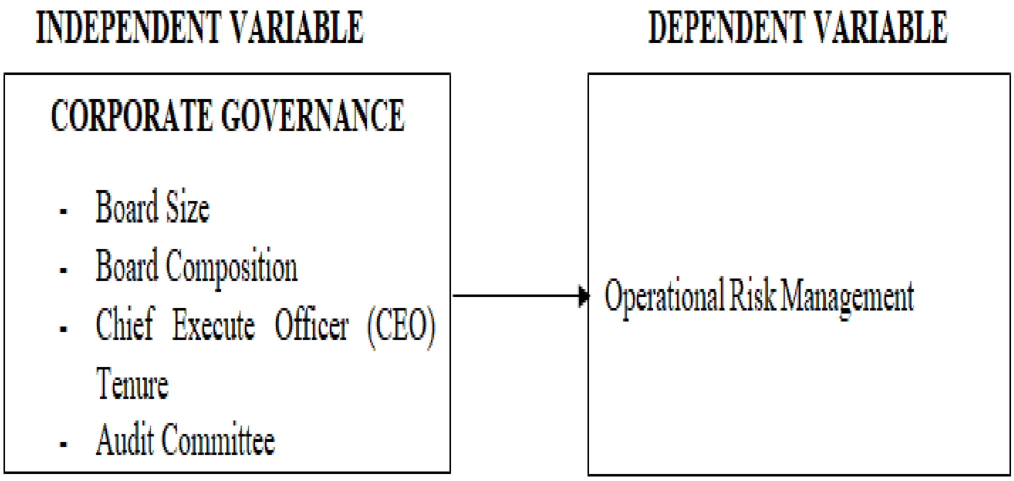


**Figure 1: Conceptual Framework Model.**

## Proposed Research Questions

To achieve this study's objectives, the following research questions were formulated.

- To what extent corporate governance can strengthen operational risk management in the Nigerian deposit money banks (DMBs)?
- To what extent does operational risk management can mitigate Nigerian deposit money banks (DMBs) against exposure to risk.
- What are the barriers hindering the operational risk management in the Nigerian deposit money banks (DMBs) against exposure to risk?
- What are the possible remedies to the barriers of a sound operational risk management in the Nigerian deposit money banks?

## CONCLUSIONS

This paper develops the conceptual framework for the relationship between corporate governance and operational risk management of the listed deposit money banks in Nigeria. The study has been able to establish a model which corporate governance will be used as an independent variable with the following constructs: Board Size, Board Composition, Chief Execute Status and Audit Committee. While risk management will be used as a dependent variable. The importance of an effective governance framework in the prevention of banking risks has been recognized in financial literature. In the business sector, corporate governance plays an important role. In a business, good governance assures the company's performance and competitiveness. Banks also serve as contract intermediaries in the financial sector. It provides clients with a variety of contracts from which to pick. Good governance reduces agency difficulties that limit business expansion. It is especially crucial for the bank because it works with other monies on a trust basis. In the financial market, the bank serves as a contract middleman. It provides clients with a variety of contracts from which to pick.

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