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Risk Management and the Financial Performance of Commercial Banks in Nigeria: A Literature Review Revisited

Olalere Oluwaseyi Ebenezer[1], Dr. Wan Ahmad Bin Omar[2]
[1]*School of Business Innovation and Technopreneurship, Universiti Malaysia Perlis, 01000, Kangar, Perlis, Malaysia.*
[2]*School of Business Innovation and Technopreneurship, Universiti Malaysia Perlis, 01000, Kangar, Perlis, Malaysia.*

Abstract : *The study was designed to evaluate the influence of risk management practices on bank financial performance in Nigeria. Of a truth, financial institutions around the world has proven that risk management are indispensable for banks that aim at sustaining its financial viability and operational service efficiency. Researchers, analyst and financial institutions authorities have observed that poor management of risk, high redundancy, miss-management and waste often result in failure and low profit margins. Thus, it is of paramount importance to explore how risk management affects performance, banks operations and provision of services. However, the objective of this paper is to study the significant of risk management and the financial performance of banks given a highly competitive market. The paper is an ongoing research on risk management and financial performance in the banking industry in Nigeria. It establish that poor risk management reduced profitability and it results to low profit margin of the company or be more extraneous in highly competitive market. Hence, the paper concludes that for profitability to be attained, the bank must adhere its financial operations with different regulations and guidelines.*

Keywords: *Risk management, financial performance, banks, and financial institutions.*

I. Introduction

Since the inception of banking in Nigeria in the early years, the studies on risk management and their effect on performance have been very active. Though numerous reports have investigates risk management and performance in various part of the world (see [1], [2], [3], [4]; and others). Albeit, the aim this study is to reinvestigate the nature of risk management and its resultant effect on performance. Hence, the management of risk in the financial institutions is not as simple, for two reasons. First, because the implications of poor risk management can have significant impacts for a wider number of stakeholders including shareholders, employees, the national and local economies. And second, because the nature of risk within the organizations is far more complex than the simple risks we have to manage as individuals. Managing risk is an essential skill of all modern financial corporations, and for those who manage risk well, the rewards can be great [5]. Obviously, it is widely believed that risk has been a subject of debate among many researchers for the past few decades. In fact, from ancient time, at the emergence of the banking era, financial institutions practice risk management in order to survive. As a result of competitiveness, the practice of survival instinct led financial institutions in the avoidance of risk threatening their existence.

In reality, risk are uncertainties and in the banking universe, financial institutions are face with large number of risk. Even though, Bankruptcy in the financial sector are costly, not only for the equity and debt holders of banks' but also to the taxpayers and the main goal of bank's management is to maximize the shareholder's value. So, avoiding all risk would result in no achievement, no progress and of course, no reward. Hence, risk is associated with the likelihood of a negative outcome. However, in management, risk is the chance that an investment's actual return will be different than expected and a fundamental idea in finance is the relationship between risk and return on investment. Thus, the paper examines risk management and the financial performance of commercial banks in Nigeria.

1.1 Paper Objective

The main objective of the paper is to review literature on risk management and the financial performance with particular reference to commercial banks.

II. Literature

Generally, risk has a very long history as it can be said to have been in existence like human existence. It has defiled a universal definition as every author's attempt display a different orientation [6]. In fact, businesses in every aspect are faced with a lot of uncertainties in their operations. No doubt, the risk incurred by

banks differs from financial to non-financial risk in the present changeable and unstable economic environment [7]. The Financial crisis has not only rocked big economies of the world, but developing economies have been badly affected. Many financial institutions have either collapsed and or are facing near collapse because of badly functioned subprime mortgage lending to firms and people with bad and unreliable credit. Banking crisis in Nigeria has shown that not only do banks often take excessive risks, but also the risks differ across banks [8].
[9]notes that in today's dynamic environment, all banks are exposed to a large number of risks such as credit, liquidity risk, foreign exchange risk, market risk and interest rate risk, among others- the risk which may create some source of threat for a bank's survival and success. Financial institutions are business organizations that act as mobilizers and depositories of savings, and as sources of credit or finance [10]. They render services such as resource mobilization and allocation, financial intermediation and facilitation of foreign exchange transactions to enhance international trade [11]. Managing risk is a difficult task for any financial institution, and increasingly becoming important in a world where economic events and financial systems are linked. Global financial institutions and banking regulators have emphasized risk management as an essential component for financial long-term success. Therefore, there is need to acknowledge the existence of risk management in today's modern world.

2.1 Risk Management

The importance of risk management has become a concept and has been given more attention from practitioners in today's competitive economic world. These cannot be underrated or overlooked as the practice of risk management minimizes financial losses to the firm [12]. Banks that manage their risks have a competitive advantage. They take risks consciously, anticipate adverse changes and protect themselves from such changes. Risk management comes with setting appropriate risk environment to protect the banks from adverse outcome or risk exposure. These can be achieved through, the identification of events into one or more broad categories of market, credit, operational and other risks, assessment of risks using data and risk model, monitoring and reporting of the risk assessments on a timely basis and the control of these risks by senior management [13]. Therefore, risk is the chance of something or an event happening that will have an effect upon set goals that is unexpected and unforeseen. Put differently risk is the possibility of deviation from a planned outcome or goal. However, financial institutions that embed risk management practices into business planning and performance management are more likely to achieve strategic and operational objectives. Conducting an enterprise risk assessment can help to prioritize and identify opportunities for improvement.

2.1.1 Why Risk Management?

The complexity of business operation in the modern world is not as simple; because financial institutions are faced with various types of risk that threatened their existence, and the miss-management or the poor management of those risk has a greater influence on the financial performance of any financial institution. As a developing country, many banks has failed in Nigeria since the inception of banking and financial institutions, and the main problem in the sector has been identified as poor risk management practices. As a result of this, the integration of risk management into the commercial bank systems, processes and culture is of crucial importance.

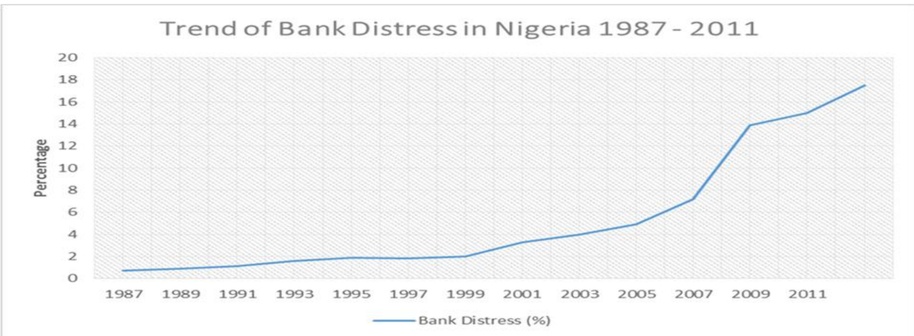

Fig. 1: The trend of bank distress in Nigeria.

Source (s): [14]

Description in the fig. above shows the trend of bank distress and one of the main causes of the rise in the bank failure in Nigeria has been attributed but not limited to the poor management of enterprise risk. As the case may be, the adoption of different risk management practice is extremely determined by; ownership of the banks, risk policies, bank regulatory environment and the caliber of management of the banks. Banks may, however, have the best financial risk management policies but may not necessarily record high financial performance.

However, it is also important to examine the recent failed banks that occurred in the banking sector in 2011. This led to the acquisition of the banks considered to be among the strongest in the banking sector at the time.

2.1.2 Details of recent failed banks in Nigeria in 2011.

The issue of bank failure in 2011 as been attributed to the following among other things, high non-performing loans, poor corporate governance, lax credit administration and failure to meet prudential ratio as liquidity and capital ratio. It is therefore important to show some of the selected financial ratio of the failed banks in Nigeria.

Table 1: Selected financial ratios of failed banks as at December 2011

Failed Banks	Capital Adequacy ratio (%)	% of net assets positions	% of shareholders fund	% of NPLs to Shareholders fund.	NPLs (N'bil)
Afribank Plc.	(-106%)	2	4	359	141
Union Bank Plc.	(-31%)	6	4	62	73
Oceanic Bank Plc.	(-13%)	6	7	130	278
Intercontinental Bank Plc.	(-84%)	7	7	105	210
Spring Bank Plc.	(-55%)	-	-	-	-
Finbank Plc.	(-106%)	5	4	411	42

Source: Annual reports of banks (2011)

Description of Table 1 above shows that capital adequacy ratio failed banks deteriorated by 6% from 10% in 2010 to 4.32% as at December 2011 which was below the prudential minimum of 10%. The significant decline was attributed to the inability of some the banks to make adequate provision for their toxic loans as recommended by the CBN/NDIC examiners during the year. As a result, the banking industry total qualifying capital (that is, the unadjusted shareholders fund), declined from N2, 201.84 billion recorded as at December 2010 to N429.60 billion as at December, 2011.

2.1.3 Total loan portfolio and NPL's of failed banks in Nigeria (2011)

The total gross loan of the five failed banks was to the tune of N2, 802 billion, 16% goes for loan extended for margin finance (N456 billion) while N487 billion representing 18% goes for Oil and Gas sector. The remaining 66% is spread to other sectors of the economy. From this data, it is clear that stock market , Oil & Gas were mostly exposed to and the state of these sectors accounted for bulk of the loans extended to them going bad or becoming non-performing. If these loans were spread out evenly to the other sectors, the risk would have been minimal. The total non-performing loans in the books of these five banks amounted to N1, 143 billion, representing 40.79% of the total loan. This means that almost half of the loans in the books of these banks are potential bad debts.

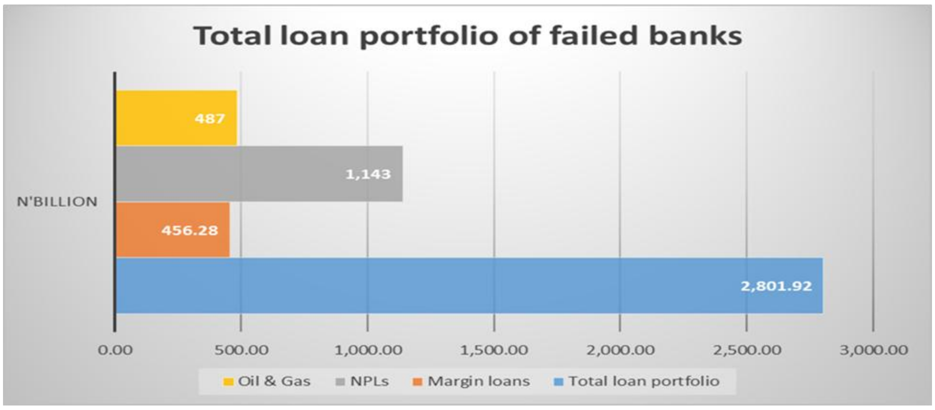

Fig. 2.5 Total loan portfolio of failed banks in 2011

Source: NDIC, 2011

Many banks across the wide range of countries suffered both from realized losses and loan rescheduling in the domestic market and from large and well publicized rescheduling of syndicated international credits. It is therefore obvious that banks fail for very many reasons including: macro-economic problems leading to enterprise failures, error in judgment or market strategy by bank management, sudden changes in market conditions such as devaluation, natural disaster or stock market crash; internal management disputes or labour problems, in-experienced staff operating in new fields; violation of regulations; connected lending to shareholders; managers or other bank staff, poor internal accounting records, and poor bank supervision, perfunctory external audit exercises.

2.2 Relationship between risk management and Financial Performance

[15], recently identified that the level of risk investment can influence on the financial performance of an organization. The study identified that financial institutions in the top 20 percent of risk maturity, where maturity was defined by the number of risk management practices applied, generate three times the level of Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA) as those in the bottom 20 percent.

Until that time, senior executives may not have perceived risk management as strategic to the enterprise, or lacked sufficient confidence in their ability to identify and address the risks that could influence the financial performance, or even the viability of their organization. This is no longer an option. Using a global, quantitative survey (based on 576 interviews with financial institutions from sixteen countries and information from 2,750 analyst and company reports), the study assessed the maturity level of risk management practices versus financial performance.

The study identified the leading risk management practices that differentiated the various maturity levels, and organized them into specific risk components. The results revealed that while most financial institutions perform the basic elements of risk management, top performers do more; and certain risk practices were consistently present in the top performers.

2.2.1 Enhance risk Strategy

For effective strategy and governance; proper oversight and accountability to the board and executive levels are critical. Ownership of risk throughout the organization is also needed and at the management level, executives play a crucial role in assessing and managing risk.

2.2.2 Embed risk management

Financial institutions that embed risk management practices into business planning and performance management are more likely to achieve strategic and operational objectives. Conducting an enterprise risk assessment can help to prioritize and identify opportunities for improvement.

2.2.3 Optimize risk management functions

By aligning and coordinating risk activities across all risk and compliance functions; organizations can reduce their risk burden (overlap and redundancy), lower their total costs, expand coverage and drive efficiency.

2.2.4 Improve controls and processes

By optimizing controls around key business processes, harnessing automated versus manual controls and continuously monitoring critical controls and key performance indicators by leveraging GRC (governance, risk management and compliance) software tools; organizations can improve performance and reduce the cost of controls spend.

2.2.5 Enable risk management, communicate risk coverage

Moving an organization from being risk-averse to risk-ready requires executives who lead by example and tone-from-the-top spot. For maximum benefit, regular and open communication with all stakeholders, third-party assurance and the leveraging of technology are required.

III. Theoretical Framework

As earlier stated, the research is an ongoing study on risk management and performance of commercial banks in Nigeria. Therefore, the research framework for this study is limited to the research problems and literature review. The framework focuses on the effect of risk management on financial performance of commercial banks in Nigeria. The independent variable is the financial risk; proxy by credit risk, liquidity risk and operational risk. Meanwhile, financial performance, which is measured by return on asset (ROA), return on equity (ROE), operating efficiency. Hence, they represent the dependent variables.

Independent variable   Dependent variable

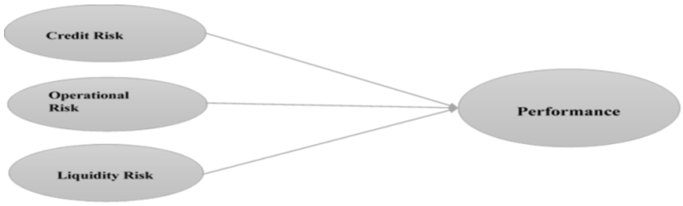

Fig. 2: Theoretical framework

Description of the fig. 2 above is apparent that the foundation of this research is built on risk management of commercial banks, specifically (credit risk, liquidity risk & operational risk). It is the foundation which makes us interested in the study of the relationship between risk management and financial performance (profitability). And more specifically, we want to find the relationship between financial risks and financial performance. We need to quantify financial risks (credit, liquidity & operational) as well as performance to disclose the relationship in a statistical and objective method. To achieve this, we actually propose to investigate the effect among the indicators chosen to represent or measure financial risks and the indicators chosen to represent financial performance. However, the information will be useful for investors, practitioners and bank managers, they are the "outsiders" concerned about the profitability of banks.

IV. Literature Findings

Risks are a serious threat to the performance of banks; therefore, we examined the effect of certain risks on banks in varying dimensions, which are in line with the finding of this paper.

One of the major findings revealed that the management of risk does not often translate to positive financial performance of banks. Although effective risk management in financial institutions reduces the occurrence of systemic and economic breakdown, but this does not guarantee an increase in the returns on equity.

Furthermore, the poor risk management and laxity on the part of management in the banking sector often lead to the deterioration in capital adequacy and have a direct influence on the shareholder's funds.

Secondly, the paper found that the drive for profitability in the banks often results in heavy debts has most financial institutions lack corporate governance as a result of laxity in credit management.

Thirdly, the findings also revealed that loans and advances are not evenly spread across sectors of the economy but rather the oil and gas and the capital market sector are mostly exposed to and the state of these sectors accounted for bulk of the loans extended to them going bad or becoming non-performing.

Finally, as may be the case with other organizations, the perceived gains of financial institutions in the level of risk management they employ is of crucial important to the shareholders. So, the right practice of risk management strategies by financial institutions into their business planning and performance management are more likely to achieve their strategic goals and operational objectives.

V. Conclusion

We now live in a world of uncertainty where commercial banks have sustained and are more likely to suffer more penury if they refuse to give risk management a top-priority consideration. In this paper, it has been found that the functions of risk management should actually be bank specific, dictated by the size and quality of the balance sheet, complexity of functions, technical/professional manpower and the status of Management Information System (MIS) in place in that bank. Balancing risk and return is not an easy task as risk is subjective and not quantifiable, whereas return is objective and measurable. However, even though numerous bank failures was caused by weak capitalization and poor risk management practice, the banking sector is believed to be stable presently, hence, this paper concludes that there were still a lot of weaknesses as identified in the [14] report such as: weakness in board and management oversight, inaccurate in financial reporting, poor book-keeping practices, non-performing insider-related facilities, declining asset quality and attendant large provisioning requirement, inadequate debt recovery efforts, significant exposures to the capital market through share loans to individuals and marginal loans to stock broking firms as well as frauds attributable to weak internal control systems. This showed that the perceived gains from this major reform did not provide a sustainable remedy to the apparently intractable problems in the Nigeria banking sector as the sector still faced a lot of challenges especially in the financial risk management. Therefore, for profitability to be attained, the bank must adhere its financial operations with different regulations and guidelines.

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