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Effect of Enterprise Risk Management Strategyon Financial Performance of listed banks at Nigeria Stock Exchange

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Abstract: The main objective of the study was to determine the effect of enterprise risk management strategy on financial performance of listed banks at Nigeria Stock Exchange (NSE). Asset Liabilities Management theory and Valuation of Derivatives theory were used to expound on the effect of enterprise risk managementon financial performance. Longitudinal cross sectional survey research design was adopted. The study's target population includes all the 28 listed banks at Nigeria stock exchange. Data was collected from 2009 to 2018 for 20 listed banks in Nigeria. The secondary data sources for the period of between 2009 and 2018 were collected from Nigeria Stock Exchange and annual reports and accounts of the listed banks. The data was collected from audited financial statements of listed banks and other relevant internal report. Data collected was subjected to diagnosis tests of normality, autocorrelation, multicollinearity, linearity, homoscedasti city, stationarity, fixed and random effects. Correlation analysis was carried out to establish the relationship between the dependent and independent variables. Generalized Least Squares (GLS) regression analysis model was used to establish the relationship and significance between the study variables. The formulated hypotheses were tested. STATA statistical software version 10 was used for data analyses. The study found out that there are positive relationship between enterprise risk management and return on capital employed which is the measure of financial performance of the listed banks at NSE. Based on the findings, the study concluded thatenterprise risk management strategies have a positive significant effect on financial performance of listed banks at NSE. The study recommends that there is need for the listed banks to effectively manage their capital buffer as it was found that enterprise risk management strategies positively affect financial performance of listed banks. The study further recommends that there is need for the management of listed banks to constantly check their banks' exposure to insolvency risk, and interest rate sensitivity.

Keywords: Enterprise Risk management, Financial Performance.

I. Introduction

Enterprise Risk Management Strategies (ERM) defines a process that combines the corporate's entire risk management activities in one integrated, holistic framework to achieve a comprehensive corporate perspective. Traditional approaches, in contrast, are generally based on a silo-based risk consideration and a department-by-department perspective where risks are measured in isolation (Kaplan*et al.*,200). Furthermore, rating agencies have started to incorporate companies' internal (enterprise) risk management systems in their rating processes.

In general, the internal factors can be reduced to the objective of risk management, which is to enhance the firm's shareholder value. ERM is also driven by methodological and technological progress including advanced methods of risk quantification and information technologies (Raghavan, 2003).

Overall, an ERM system thus enables the board and senior management to better monitor the company's risk portfolio as a whole (Beasley *et al.,* 2005). Based on the definition, ERM is a top-down approach which considers identifying, assessing and responding to strategic, operational and financial risks (Harner, 2010). However, one thing which is very clear is the failure in risk management. Allen and Carletti (2009) alluded that systemic failure in securitization by investment banks and individuals who had pooled together to provide mortgages as risk strategy did not vet the borrowers properly and therefore quality of borrowers was not taken into consideration. This led to significant losses to insurance companies and pension funds triggering collapse of other sectors. In 2008 alone pension funds in Overseas Economic Cooperation for Development (OECD) lost huge amount of US $3.5trillion in market value, down from $18.7 trillion at the end of 2007. Aggregate country-level statistics suggest that pension industry had made losses in most countries during 2008 and equity markets collapsed by 50 percent between mid-2007 and March, 2009. This was reflected in the sharply dropped aggregate investment returns among OECD countries (Allen, Babus&Carletti, 2010). Because of poor risk management during the financial crisis in 1997, different institutions were severely affected in East Asia (Hanim, Abdul-Rahman& Omar, 2011), and several major Malaysian corporations were among those affected Bank Negara Malaysia (1999) has reported that the crisis had caused a RM 45,304 m reduction in their total assets. Meanwhile, ERM has been emphasized after the recent financial crisis (Arena, Arnaboldi&Azzone, 2010).

The concept of economic capital is put forward and plays an increasingly important role in risk management. First applied in the commercial banking industry, economic capital has become a focal point in banking risk management, while for insurance companies economic capital is still in its infancy (Shafique, 2013). Economic Capital is defined as sufficient surplus to meet potential negative cash flows and reduction in value of assets or increases in value of liabilities. The economic capital was originally applied to banks, along with economic development and Mixed Financial trends, economic capital is increasingly concerned by insurance companies (Kleffne, 2003). Economic capital is quantity concept introduced in order to absorb unexpected risk loss of insurance companies, therefore, economic capital in quantity should be equal to the quantity of unexpected loss. Because of the different understanding of the risk, it is difficult to define the risk when applying economic capital (Berger *et al.,* 1995). And it's more difficult to integrate economic capitals of different single risk. In addition, there are not many researches on the construction of the economic capital management system and fewer comparative studies on the comparison between different ways of economic capital measurement,

Enterprise Risk Management in the Banking sector

The banking sector in Nigeria is evaluated among the sectors with the best performance in the economy (CBN, 2016). Loans and deposits are growing, while the rate of financial services is being increasingly advanced. The Central Bank plays the leading role and has the authority to license, supervise, and regulate financial institutions in Nigeria. The banking sector in Nigeria consists of 28 listed commercial banks and other micro finance banks. These banks provide various services for their clients including loans, guarantees, current accounts, savings accounts, time deposits, transfers in the country and abroad as well as services for storing items of value.

The Central Bank of Nigeria continues to be dedicated to ensuring financial stability in the country, which represents the main target of the law (Central Bankof Nigeria, 2014).The Central Bank of Nigeria, like all the banks of other countries, functions in accordance with the Basel II framework (Feiguine&Nikitina, 2008) that was standardized from 1 January 2008. The Basel II framework determines the minimum level of capital requirement that is required to be created by banks to maintain the funds of depositors and investments in their value. As a form of legislation, Basel II directs banks to consider the risks that they face and develop capacity for their risk management. Banks are obliged to submit their annual accounts in accordance with International Financial Reporting Standards (IFRS) and accounting standards.

Nigerian commercial banks have adopted the organisational structure of risk management by KPMG, as it better fits the business environment to mitigate potential risks (CBN Financial Supervision, 2015).

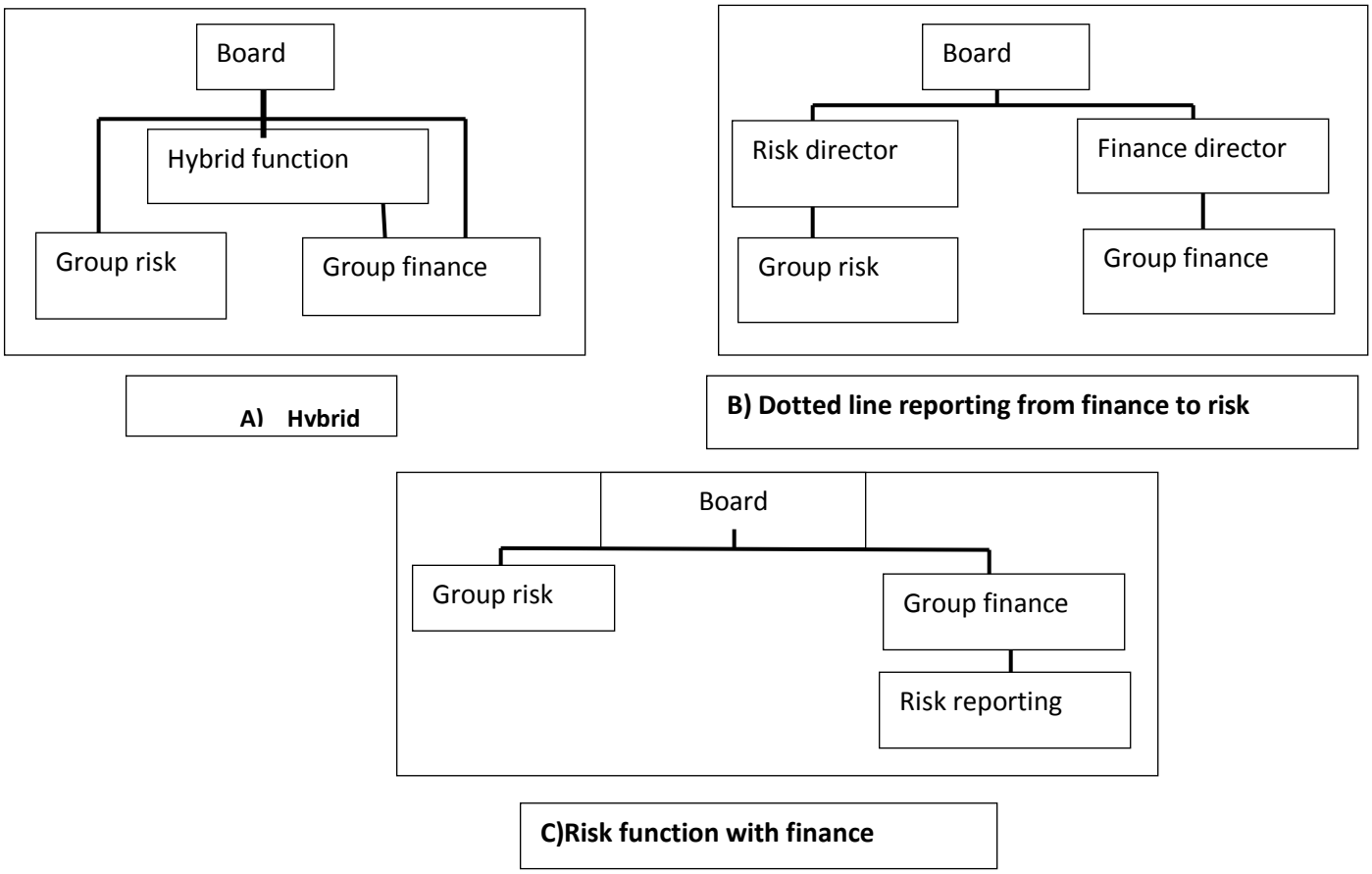

Figure 1.1. Organisational structure of risk management Source: KPMG (2011)

Diagram (a) shows that the risk and finance have a hybrid function, while diagram (b) shows that there is a special department of risk and finance which reports to the board of directors. Diagram (c) shows the risk reporting function created within the finance department, creating proper environmental risk management through sound policies and procedures. Risk management committees that exist in banks determine the policies of risk management and then make recommendations to the board of directors. As a result, strategic objectives of banks for risk management are set by the board of directors who determine the limits and suitable methods related to risk actions. A robust system for management is based on reporting of adequate processes for internal monitoring and includes appropriate procedures for granting approvals and setting deadlines. Risk assessment, monitoring, and control functions are connected to each other to meet the objectives (CBN, 2014).

The implication of Enterprise risk management on banking system for a fragile and weak financial system in Nigeria is far reaching. First, unguided financial liberalization exposes the banks and indeed the economy to excessive financial shocks. The recent financial crises in the Asian countries are a case in point (Olajide, Asaolu&Jegede, 2011). Second, continuous reforming the financial system makes the system unstable, planning difficult and indeed creates unfriendly operational environment that may affect the efficient operational performance of the banks. For instance, the ripples of universal banking introduced in 2001 have not settled before the recapitalization exercise was introduced in 2004. Similar reversal and rewriting of rules were noticed in the past reforms (Jeroh&Okoye, 2015). Nigerian banking system is fragile and marginal because of the challenges that they face; which if not addressed could result in crisis. He was of the opinion that there is need to synergize so as to benefit from economies of scale and be positioned to attract cheaper funds into the economy. A banking crisis or failure can be triggered by weakness in banking system as a result of persistent illiquidity, insolvency, undercapitalization, high level of non-performing loans and weak corporate governance (Oluitan, Ashamu&Ogunkenu, 2015).

II. Financial Performance of Commercial Banks in Nigeria.

Financial Performance in broader sense refers to the degree to which financial objectives has been accomplished and is an important aspect of risk management. It is the process of measuring the results of a MRH's policies and operations in monetary terms (Damondaran 2013). The significant changes that have occurred in the financial sector of developing economy like Nigeria have increased the importance of performance analysis of modern banks. Casu et al (2006) observed that performance analysis is an important tool used by various agents operating either internally to the bank or who form part of the bank's external operating environment. Among the large set of performance measures for banks used by academics and practitioners alike, a distinction can be made between traditional, economic and market-based measures of performance. Traditional measures of performance are similar to those applied in other industries, with return on assets (ROA), return on equity (ROE) or price earning(P/E) ratio being the most widely used as external measure of performance. In addition, given the importance of the intermediation function for banks, net interest margin is typically monitored. The return on assets (ROA) is the net income for the year divided by total assets, usually the average value over the year. Return on assets equals net income / average total assets.

Another major yardstick for measuring performance in the banking industry is the CAMEL approach. This approach is equally used by the monitoring authority to assess the level of performance of banks, before making any pronouncement on their soundness, solvency and liquidity position. The acronym CAMEL means: C= Capital Adequacy A= Assets M= Management E= Earning L= Liquidity.This serves as a major tool for assessing solvency level of banks by the monitoring authority.

III. Research problem

This study arises from the need to manage enterprise risks effectively and efficiently through the application of ERM strategies keeping in mind effect on financial performance of a firm. Theoretically, risk management plays a key role in improving firms' financial performance (Kaplan *et al.,* 2008). According to Beasley *et al.* (2008) ERM is intended to promote awareness of the sources of risks and address them by improving strategic and operational decision making. As a result of improved efficiency, firm performance should increase, volatility should decrease and cost of capital should be reduced thus firm value should increase. Lawrence *et al.* (2009) state that there is a growing support for the general argument that organizations improve their performance by employing the ERM concept. Nevertheless, the findings of some other researchers highlight the fact that adoption of ERM has no value implication on firms. For example, according to Pagach*et al.* (2010) in their study on "the effects of ERM on firm performance" results fail to find support to the proposition that ERM is value creating. Similarly, according to Otieno (2012) and Li *et al.* (2014) their findings fail to support the theoretical expectation that ERM has a positive impact on firm performance. The findings of these researchers put forward some mixed result in the premise that ERM has an implication on firm performance and value.

In Nigeria context it was observed that ERM has not been applied by the management of banks effectively, thus, there has been negative effect on banks financial performance. As a result of this, weak financial performance is attributed to increasing risks, similarly, there is no consensus on how firms could leverage on risk management to improve financial performance. The statistics in Nigeria on weak financial performance is attributed to increasing risks, traditional risks were evolving and new risks emerging. The findings also indicated that risks were manifested in the increasing economic crime and fraud (PWC, 2014; Waweru&Kisaka, 2012; KPMG, 2011). If these situation is left unattended to there could be more complex effect on the financial performance of banks and the economy at large. The effect could be risk on liquidity level of banks, instability in the financial strength and subsequent bankruptcy as a result of financial failure. This therefore means that there could be some underlying issues that have not been addressed in ERM.

IV. Objective

The main objective of the study will be to determine the effect of enterprise risk management strategies on financial performance of listed banks at Nigeria Stock Exchange.

Specific Objective

The study will be guided by the following specific objective;

i. To evaluate the effect of economic capital risk management on financial performance of listed banks at Nigeria Stock Exchange.

Research Hypotheses

H_{01} Economic capital risk management has no significant effect on financial performance of listed banks at Nigeria Stock Exchange

V. The scope of the study

This study combined theoretical considerations (Asset Liabilities Management theory and Valuation of derivatives theory), in providing better conceptualization of the effect of enterprise risk management strategies on financial performance of listed banks in Nigeria Stock Exchange. The theories were found relevant in view of the practice of valuation of derivatives theory approach provides an explanation of the diversity of Market Risk Hedging in reality and asset liabilities management theory is found to be relevant to the study based on the fact that for banks to achieve good financial performance, they must strive to carefully manage their asset and liability structure well so as to avoid mismatch.. The study focuses on enterprise risk management in the Nigerian banking sector and how it has affected the financial performance of listed banks at the Nigeria Stock Exchange. This study gave special and specific focus to concept of risk management with a view to examining how to improve or enhance its practice in the Nigerian banking industry. The study population comprised of 28 listed banks at NSE that are actually engaged in risk management process whose financial performance impacts (otherwise) on the economic development of the country. The study's period is 10 years from 2009 to 2018. The scope of this study include the bank-specific attributes of Risk Hedging derivatives whose operational and professional roles in banking business cannot be quantified. This is a special attribute that impact on the financial performance of banks, generally.

VI. Literature Review

Asset Liabilities ManagementTheory

Ronald (2013) of the Research Foundation of Chartered Financial Analysts (CFA) Institute, reported that the evolution and history of asset liability management is littered with false starts. It dates back to the historical period from roughly 1875, when the corporate pension was established in the US (CFA, 2013). According to Ronald (2013), the most prolific author on Asset Liability Management (ALM) is Martin Leibowitz who authored many books and papers for 40 years on it. The evolution started with the idea of dedication which means matching of a stream of cash flow (assets) to a stream of cash flow (liability), such that each cash inflow was dedicated to paying a particular outflow of cash (Ronald, 2013).The theory is found to be relevant to the study based on the fact that for banks to achieve good financial performance, they must strive to carefully manage their asset and liability structure well so as to avoid mismatch. As a strategic option plan, the entire branches of the bank must be involved especially as it relates to liquidity and interest rate risks management information of the bank either through the Asset Liability Management Committee. Although, it must be borne in mind by bank managers that there is no complete or best model in place for asset and liability structure bearing in mind that there are multitude of models (Saksonova, 2011). It therefore beholds on the banks to perform these key functions efficiently, prudently and profitably as economic agents that promotes growth and ensuring financial system stability. Thompson (1981), warned that the model of immunization were vulnerable to interest rate risks which is an aspect of ALM

Valuation of Derivatives Theory

The first "modern" futures exchange was in existence as early as 1730 in Japan (Schaede, 1989). Early discussions on the pricing of options and forwards include Bachelier (1900), Keynes (1930) and Hicks (1934). However the issue of how to price options remained dormant until the 1960s when Samuleson (1965), whose interest was aroused by the rediscovered Bachelier dissertation, again considered this problem. Uncharacteristically for Samuelson, he was unable to solve the problem. His work and that of a number of others was lacking one final insight: assets that are subject to the same risks must trade for the same price. If they do not, then the market would offer arbitrage opportunities - something that cannot exist in a well-functioning market. The same concept was used by two of Samuelson's MIT colleagues, Modigliani and Miller (1958), to prove their famous capital structure proposition.

The breakthrough was achieved in the seminal Black and Scholes (1973)model. Black and Scholes focus on valuing "European" options (these are options that allow exercise on only one date), as distinct from "American" options (which have the added flexibility that the buyer can exercise the option at any timeup to the final exercise date). They develop a closed form solution for the price of a European call option on a common stock. The underlying idea is that an investor

could exactly replicate the payoff of the option by trading at each point in time in the stock and a riskless bond. This trading strategy should be self-financing, it should have an initial cost, but then require no other cash inflows or outflows until the terminal date, when the payoff should exactly match the payoff of the derivative. For the market to be free from arbitrage opportunities, the cost of the replicating strategy must be the exact price of the option.

Black and Scholes show that the option pricing formula must satisfy a partial differential equation with associated boundary conditions for which they are able to give a closed form solution. Moreover, they explicitly identify the trading or hedging strategy needed to replicate the option. A startling result in the Black-Scholes analysis is that the expected rate of return of the underlying asset is completely absent from the pricing equation. Even Black and Scholes found it hard to provide a good intuition for this result, as can be seen by their comment that "The option value as a function of the stock price is independent of the expected return on the stock. The expected return on the option, however, will depend on the expected return on the stock. The faster the stock price rises, the faster the option price will rise through the functional relationship.

VII. Empirical Review

This section contains review of previous literature related to the effect of various risk management strategies on financial performance. Empirical review was done to identify the research and knowledge gaps in this field of risk management strategies and financial performance of listed banks at NSE.

The Empirical Analysis on the Economic Capital of the Business Lines in the Chinese Property Insurance Company " (2008) considering the relationship between the various lines of business. By building economic capital allocation models and empirical research results show that: the total amount of economic capital of every product business line of various property insurance companies sums up to an average of 15% of their total premiums. RAROC of each product business line of each insurance company has large difference from others, that is, the risk benefit status of each business line has large difference. Accordingly, different types of insurance underwriting strategy and reinsurance strategy should be taken to balance various lines of product business RAROC indicators. Comparing domestic and international research, it can be found that the current exploration of economic capital in China is concentrated in the commercial banks and the application for insurance companies is still in the primary stage.

Risk assessment enables the insurance companies to detect risks on time and concentrate on high risk areas leading to increased transparency and accountability and enhanced financial performance of insurance companies. Thus the study has found a strong association between risks monitoring practices as a control system and financial performance of insurance companies. This study will be conducted in listed banks which is basically money market as against capital market of insurance.

Moreover, a more recent study in the U.S.by Adamu, Zubairu, Ibrahim and Ibrahim (2011) that investigated the determinants of hedging in lodging firms from 2000 to 2004 also found that underinvestment costs measured by market value to book value have a positive and significant relationship with derivative usage in lodging firms (Singh &Upneja, 2007). Furthermore, the same results are found in developing countries such as Taiwan, Pakistan, and Malaysia. A study in Taiwan found that the growth potential of a firm measured by the equity-market-to-book-value ratio has a positively significant relationship with the use of derivatives for companies listed in the Taiwan Exchange (Shu& Chen, 2003). The same proxy is used to measure the underinvestment costs of firms in Pakistan and has the same result (Afza&Alam, 2011).

Doaei, Ahmad and Ismail focused on a study in the U.S. in 1993 using the ratio of research and development expenditure to firm size as a growth proxy found that the growth opportunities of firms have a positive association with derivative usage (Howton& Perfect, 1998). Therefore, whenever firms are in a tight financial situation and have to forego positive NPV projects, hedging helps to reduce the firm's underinvestment costs.

Furthermore, a study conducted in Nigeria between 2006 and 2009 on 200 firms found that leverage is insignificant with derivative usage and is not be one of the driving forces of the probability of derivative usage in Nigerian firms (Fosu (2013)). Investment opportunities can be improved by using derivatives to hedge against underinvestment costs and fluctuations in firm earnings (Shaari, et al., 2013). This finding is aligned with that of a study in Australia that uses the market-to-bookvalue ratio as a proxy for investment opportunities and found it to be significant to derivative usage in firms (Nguyen & Faff, 2002). A study conducted on U.S. firms in 1995 discovered that all proxies for growth options are significant and positive with derivative usage. The study uses five types of ratios as growth option proxies. The ratios are research and development expenses to firm size, market value of equity to book value of debt, price earnings ratio, market-adjusted cumulative abnormal return and cash and short-term investment to total assets (Gay & Nam, 1998).

Ziaee (2014) conducted a study on the effect of Economic capital management on the performance of listed companies in Tehran Stock Exchange. This study sought to examine the relationship between Economic capital management and financial performance of financial companies in Iran**.** For this population the financial risk management is accepted in Tehran Stock Exchange and 2008 to 2012 have been selected. Questionnaires were distributed and they reached the conclusion that audit quality could not affect the financial performance of companies. This study will examine the effect of Economic capital on financial performance of listed banks in Nigeria with a secondary source data of audited financial report.

VIII. Methodology

Introduction

The study used panel data to carry out the research analysis for 10 years starting from 2009 till 2018. The study examined the data in order to know which model will be adopted from fixed effect and random effect model. In the case of fixed effect model, it was assumed that the variables that have effect on financial performance vary over time but have fixed effect across the entire period under study. Assumption of the fixed effect model include homogeneity of the estimates across the entities and the error term between the entities $\mu_{it}$is equal to zero. A fixed effect model assumes correlation between error term $\mu_{it}$and the predictor variables. However, in the case of a random effect model, the variation across entities is assumed to be random. The error term between the entities $\mu_{it}$is equal to zero and is estimated(Guharati, 2003).

The fixed effect model and random effect model is given in equation 1 and 2 respectively below:

$Y_{it} = \beta + \beta_i X_{it} + \varepsilon_{it}$ ……Fixed effect model (Equation 1)

$Y_{it} = \beta + \beta_i X_{it} + \mu_{it} + \varepsilon_{it}$ ……Random effect model (Equation 2)

A Hausman test was carried out to investigate whether the data collected violated the assumption of the fixed effect model and to know which model to adopt. The null hypothesis for Hausman is the preferred model is the random effect model. The decision rule is based on Chi-Square statistic p-value of the Hausaman test less than 0.05 indicated that the preferred model is the random effect model otherwise, it is fixed effect (Torres-Reyna, 2007).

The following model was used in line with the objectives of the study:

$Y_{it} = \beta_0 + \beta_1 X_{1it}$ ……..1

Where: Y_{it} —Dependent Variable:

Y_{it}--- Financial Performance (ROCE),

X_1= Economic Capital Management.

8. Findings

The objective of the study was to establish the effect of economic capital management on financial performance of listed banks at Nigeria Stock Exchange. The GLS was fitted to empirically determine the effect of Enterprise Risk Management strategy on financial performance of listed banks at Nigeria Stock Exchange. The indicator was Economic Capital Management. The results of which were as presented in Table 1. The Wald Chi-square statistic was 6.74 with the p-value of 0.0094 for Economic Capital Management which is less than the alpha value =0.05. The implication of this was that the GLS model fitted is generally significant and that the estimated coefficients of the explanatory variables are jointly equal to zero. This means that Economic Capital Management has significant effect on the financial performance of the listed banks at Nigeria stock Exchange.

Table 1: Generalized Least Squares Model Summary for Economic Capital Management

Coefficients: generalized least squares

Panels: homoscedatic

Model Statistics			**Panel observation**
		Number of obs	200
Estimated covariances	1	Number of groups	199
Estimated autocorrelations	0		
Estimated coefficients	2	Obs. Per group: min	1
Wald chi2(4)	6.74		
Prob> chi2	0.0094		

The model coefficients estimates are presented in Table 2 The coefficient estimate of Economic Capital Management was found to be 0.001923 with z statistic 2.60. The p-value of the coefficient was less than 0.05. This implied that Economic Capital Management has effect on the financial performance of the listed banks at Nigeria stock Exchange. This result was similar to the findings of Faisal, Melati, Lim, and Hashim (2011).However, it contradicts the findings of Al-Matari, Al-Swidi and Fadzil (2014).The equation generated from the model fitted is given next.

$Y_{it} = .0001636 + .001963ECM_{IACit}$

Table 2: Coefficients Table- Generalized Least Squares Univariate Model for Economic Capital Management

	Coefficient	**Std. Err.**	**Z**	**P>|z|**
CS_{IAC}	.001923	.0007405	2.60	0.009
Constant	.0001636	.0004738	0.35	0.730

Economic Capital Management and financial performance of listed Banks at NSE

The objective is to investigate the economic capital management and financial performance of listed Banks at NSE. The result from the descriptive statistics indicated that bank risk monitoring activities has a high mean value with low degree of variability and dispersions in the model. This suggests that not many banks were all involved in the practice of market risk hedging activities. It might however be possible that they were using other risk management strategies during the period. The coefficients of correlation showed that economic capital managementwas positively related to financial performance of the banks. Panel least regression analysis also confirmed andeconomic capital managementhas statistical significant influence on financial performance of the listed banks. The relevant theories which could interpret these findings are: asset liabilities theory stating that each organization has to choose the most suitable monitoring systems by taking into account suitable matching characteristics especially in a dynamic and turbulent environment likeNigeria.

IX. Recommendations

With increased competition, the need to be efficient in banking operation requires continuous update of knowledge all over the world. Drawing from the findings and the conclusions of this study, the following recommendations (managerial and policy based) are presented so as to improve risk management and financial performance of listed banks at Nigeria Stock Exchange.

Managerial Recommendation

Economic Capital Management for the banks must be improved for it to commensurate with present operational activities or realities of the banks. Its review must be the focus of the regulators of the industry and should be continuous or time frame bound. Banks should also work on their operational expenses particularly overhead which constitute larger part of the expenses they daily incur. This will no doubt go a long way to reducing total expenses of the banks and improve profitability and financial performance generally for the listedbanks. They should specifically work on share price and earnings of the banks as a major components of the bank's financial performance.

Policy Recommendation

The present risk monitoring process laid down by the CBN seems not to be adequate for the present banking activities in Nigeria anymore. In agreement with prior recommendations, the regulatory and monitoring machinery of the CBN and other allied institutions should improve on the use of ICT. The IMF report of Article IV consultation had advised the CBN to conduct risk management review, so as to identify any potential risk management requirements for the Nigerian banking system. To this end, credit risk management reporting as a vital instrument to monitoring bad loan/credit management is advocated for all banks, in line with the submission of the Credit Bureau Association ofNigeria.

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