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Research Article

Corporate Governance and Risk Management in Banking Institutions

Sweety Rani Dhar[1,*], Al Modabbir Zaman[1], Tahmina Akther[2]

[1]*Department of Business Administration, International American University, #1000 Los Angeles, CA 90010, USA*

[2]*Department of Business Management, Monroe University, 700 University Avenue. Monroe, LA 71209*

**Corresponding Author:* *Sweetyranidhar@gmail.com*

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ABSTRACT

This study investigates the correlation between corporate governance and risk management in banks operating in the Gulf Cooperation Council (GCC) countries. The objective is to enhance the existing body of knowledge by presenting empirical data from the banking industry in the GCC region. This data examines the relationship between risk management and corporate governance attributes, including role duality, board size, and the proportion of nonexecutives. The hypotheses and proposed model were tested using non-parametric regression, quantile analysis, and panel data analysis on a sample of 900 observations from banks in the Gulf countries. The study utilizes data from financial institutions in the Gulf countries spanning from 2003 to 2012. The findings indicate that having several roles and larger board size are linked to a decrease in risk management. Conversely, the proportion of non-executive members on the board was determined to be negligible. Furthermore, the findings suggest a strong and positive correlation between government ownership and the use of risk management strategies. The findings indicate that Islamic banks have a strong and meaningful correlation with risk management, as measured by the capital adequacy ratio. The findings imply the need for more investigation into the correlation between risk management and alternative ownership structures, such as institutional ownership. Future studies can prioritize the examination of risk management frameworks and procedures specific to Islamic banks, given that these banks possess unique risks.

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1. Introduction

Investors and regulators have become significantly concerned due to the recent corporate scandals that have occurred in financial institutions globally (Aebi et al., 2012). Whether the global financial crisis was caused by excessive risk-taking or by the rising levels of risk faced by firms, both perspectives agree that risk is the main factor and emphasize the need for a suitable corporate governance structure to manage risk effectively (Elbahar, 2016). The main objective of this article is to determine the factors that are linked to the assessment of potential risks in the Australian financial industry. Australia's banking sector holds the highest market capitalization among all industry sectors. In June 2011, the financial sector of Australia consisted of 288 businesses with a combined market value of AU$455.7 billion (Akindele, 2012). The financial industry includes trading and investment banks, asset managers, insurance businesses, real estate investment trusts (REITs), and other financial service providers. Employers in all sectors in Australia are obligated to contribute to a mandatory employee superannuation system.1 Australia possesses the fourth largest pension fund pool globally, which presents significant prospects for banks, asset management firms, financial planning entities, and insurance organizations (Bastomi et al., 2017). Two Therefore, the governance practices of this sector play a crucial role in the economic well-being of Australia.

Agency theory posits that there are contrasting risk preferences between risk-neutral (diversified) shareholders and risk-averse managers, which requires oversight from the board (Bunea, 2013). Therefore, in the absence of monitoring, cautious managers may decline lucrative (yet riskier) projects that are appealing to shareholders who prioritize the higher potential return associated with greater risk. Nonfinancial enterprises do not consider excessive managerial risk-taking hazardous because the failure of one firm will not have a directional impact on the portfolio of a diversified investor. The failure of a financial institution that is of significant importance to the whole system raises the probability that

*Corresponding author: Sweetyranidhar@gmail.com (Sweety Rani Dhar)

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other financial firms will also fail (Allahrakha, 2023; Desai et al., 2008; Ngoepe et al., 2010; Zwass, 2003). This is because the contraction of the financial sector can have a cascade impact, as was observed during the Global Financial Crisis. Hence, it is crucial to closely monitor and oversee the propensity of management to engage in excessive risk-taking, especially within the financial sector (John et al., 2016). The risk management committee and the compensation committee share the responsibility of monitoring and overseeing the risk-related operations of firms. Therefore, a compensation or risk committee that mitigates excessive risk-taking and the likelihood of failure of a systemically important financial institution will be advantageous for diversified shareholders (Guo & Liang, 2016; Javaid et al., 2022; Kreutz & Jahankhani, 2024; Roberts & Brown, 2017; Webb et al., 2014; Wu, 2024).

This study examines the correlation between the risk management committee (RC) and compensation committee (CC) and the amount of risk and performance in financial businesses. We propose that the size, makeup, and function of committees should be tailored to reflect their motivation and capacity to enhance risk-taking in a manner that aligns with the interests of shareholders (Pirson & Turnbull, 2011). Consequently, the article anticipates a favorable correlation between risk and the configuration of the RC and CC. In addition, we propose that companies facing rising levels of risk should have a Risk Committee (RC) and a Compliance Committee (CC) in place to oversee and control risk in order to establish a favorable correlation between risk and performance (Hopt, 2013). The research findings indicate that the characteristics of RC (Risk Culture) and CC (Corporate Culture) play a significant effect in determining the amount of risk inside an organization. We employ a principal components analysis to calculate a factor score for the attributes of the committees, and we utilize beta as the metric for risk (Mardiana & Purnamasari, 2018). Distribution of banks shown in Fig. 1.

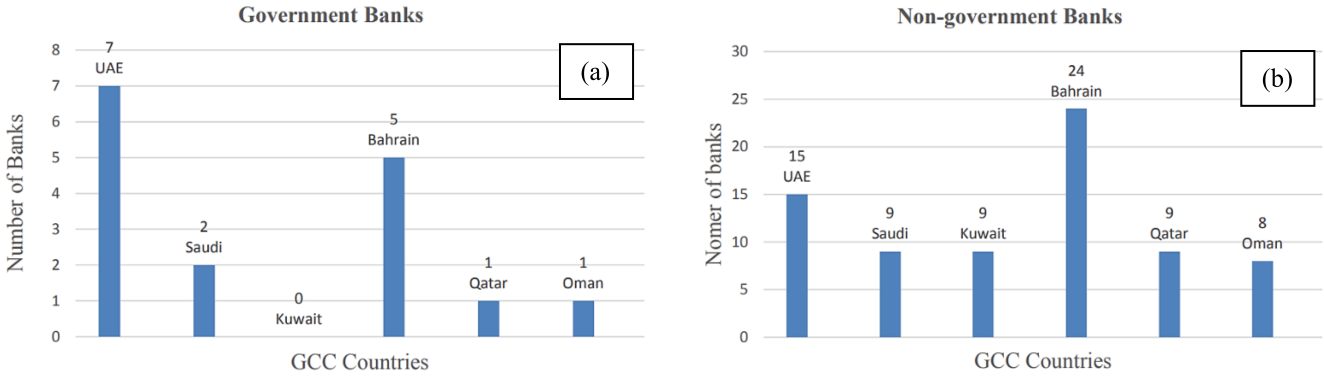

Fig. 1. Distribution of banks (a) Government bank (b) Non-government bank (Elbahar, 2016).

This research also examines the correlation between risk and performance when directors have positions on both committees, which is referred to as "dual membership". The study reveals a direct correlation between risk and performance when committee members concurrently serve on both the Risk Committee (RC) and the Compensation Committee (CC) (Himaj, 2014). This outcome illustrates a reduction in information asymmetry when directors have dual responsibilities on committees, as they may effectively supervise the relationship between the firm's risk exposure and the extent of risk-based incentives in pay plans. Consequently, making better-informed judgments leads to a favorable correlation between risk and performance. The outcome is unchanged when accounting for endogeneity (Hossain et al., 2019; Lang & Jagtiani, 2010).

1.1. Significance of this study

This work makes several significant contributions to the existing body of literature. As far as we know, no other study has conducted an empirical test to determine if directors who are members of both the Risk Committee (RC) and the Compensation Committee (CC) are effectively monitoring both the risk level of the company and the riskiness of compensation packages. The existing literature on dual committee participation is primarily theoretical and lacks in-depth investigation (Zagorchev & Gao, 2015). The coordination between the risk control (RC) and compliance (CC) departments decreases information asymmetries that impact the performance of the firm. Although certain studies indicate that board committees enhance firm performance, there is a lack of research on these committees in Australian corporations, specifically regarding their impact on risk and firm performance. Australia offers a compelling context to examine the advantages and disadvantages of board sub-committees.

In previous research, financial sector firms such as banks, diversified financial companies, insurance companies, and real-estate investment trusts have been intentionally excluded due to their higher level of risk compared to other firms. This exclusion is necessary to avoid issues with generalizability and transferability. The Australian Prudential Regulation Authority has created a framework to regulate financial institutions. Please refer to Appendix A for more details. The Prudential Standard APS 510 specifies the prerequisites in terms of skills, knowledge, and experience for directors engaged in risk management (Bunea et al., 2013).

Recently, there has been significant criticism directed towards banks and financial institutions for granting exorbitant bonuses to certain executive directors and senior management. This criticism arises during a period when the world is experiencing the aftermath of a global financial crisis, which is believed to have been caused by reckless risk-taking by financial institutions. This study adds to the existing body of literature by addressing the lack of research on the potential correlation between the remuneration and risk management strategies employed by the financial sector and the degree of risk and corresponding return. Considering that Australian corporations have the option to establish RC (Risk Committee) and CC (Compensation Committee) voluntarily, it is understandable that the extent of impact exerted by these committees has not been thoroughly investigated. Fig. 2 shows main element of this study .

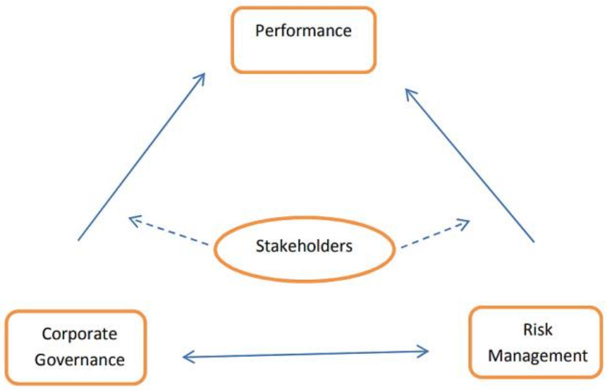

Fig. 2. Main element of this study (Tao & Hutchinson, 2013).

2. Hypothesis development

Financial institutions have evolved into sizable and intricate entities that include substantial delegation of decision-making and responsibility for taking risks. Therefore, it is challenging to create internal procedures that guarantee that the outcomes of delegated decision-making are in line with the differing goals of the principal and agent. Information asymmetry in the banking industry arises from intricate transactions, such as the challenge of assessing loan quality, the presence of opaque financial engineering, the complexity of financial statements, the ease of modifying investment risk, and the managers' relatively effortless acquisition of perquisites. The board plays a crucial role in monitoring managers' behavior and providing guidance on risk management, strategy identification, and implementation within a context of restricted competition, strict regulation, and significant informational asymmetries.

Agency theory posits that the board of directors plays a crucial role in corporate governance. This is because the characteristics of the board members directly impact their ability to monitor and control managers, provide guidance and information to managers, ensure compliance with laws and regulations, and establish connections between the corporation and the external environment. Most of the extant literature primarily examines the board's properties, such as its composition and size.

Nevertheless, many authors contend that the internal administrative structure of a board is more crucial when assessing its effectiveness. The board of directors delegates its authority to specific committees that specialize in particular areas. The ASX CGC in Australia has established rules about risk management strategies in publicly listed firms, placing the duty on boards of directors. These guidelines specifically advise firms to create a compensation committee (CC) and a risk management committee (RC) to enhance corporate governance, particularly in the area of risk management. Fig. 3 shows the hypothesis selected in this study.

Board sub-committees are created to support the board in carrying out its duties, especially when there are additional obligations and pressures on the board. Compensation and risk committees serve as crucial corporate governance tools that safeguard shareholders' interests by offering impartial supervision of diverse board operations. Studies indicate that distinct committees exert greater effect on corporate performance, corporate strategy, and the mitigation of agency problems compared to the entire board. Committees play a crucial role in organizations with high agency costs, such as those with high risk, leverage, complexity, and enormous scale. Additionally, agency theory proposes that committee performance can be influenced by features such as independence and the presence of an independent chairman.

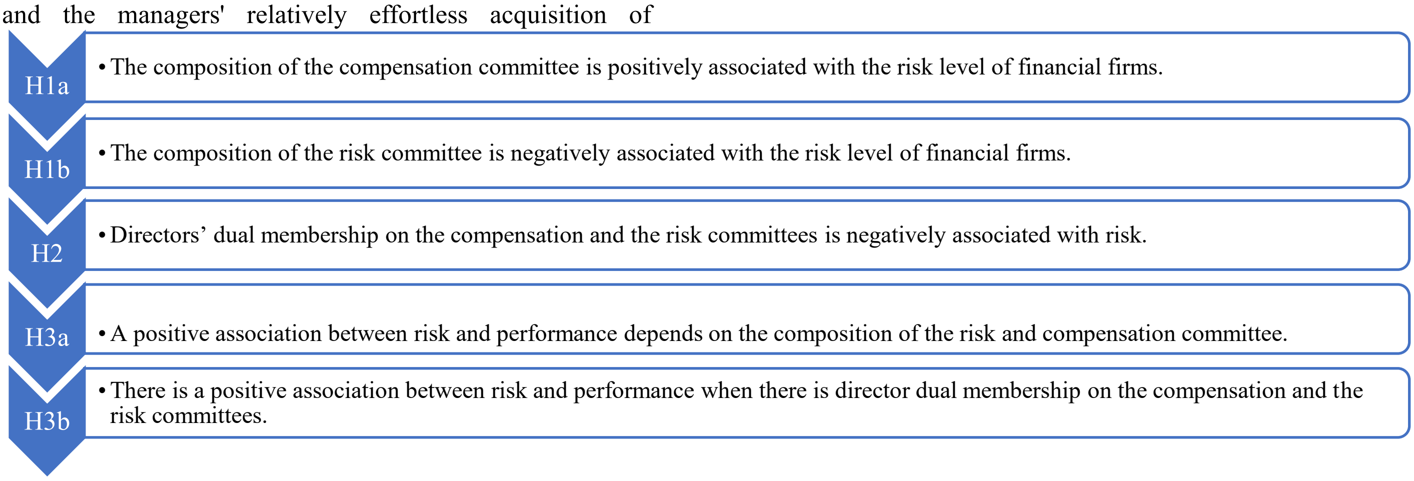

Fig. 3. Hypothesis selected in this study.

3. Results

Table 1 displays the outcomes of the factor analysis. Panel A displays the estimated communalities for each of the five committee efficacy indicators. Panel B displays the eigenvalues of the reduced correlation matrix for the five committee efficacy measures. Panel C displays the associations between the common factor and the five measures of committee efficacy. The extracted components account for approximately 50% of the variance in the original five variables.

Table 1. Analysis output (Tao & Hutchinson, 2013).

	CC	RC
Panel A: Estimated communalities of five measures of committee efficacy		
Committee independence	0.448	0.704
Proportion of committee with 10 or more years experience in the financial industry	0.660	0.716
Proportion of committee directors with 10 or more years experience on the board	0.236	0.674
Proportion of committee directors with an accounting and/or finance qualification	0.560	0.649
Committee meeting frequency	0.575	0.780

Component	Eigenvalues			
	Total CC	Cumulative % CC	Total RC	Cumulative % RC
Panel B: Eigenvalues of the reduced correlation matrix of committee efficacy measures				
Committee independence	1.325	26.509	1.381	27.616
Proportion of committee with 10 or more years experience in the financial industry	1.153	49.577	1.122	50.052
Proportion of committee with 10 or more years experience on the board	0.994	69.458	1.020	70.450
Proportion of committee with an accounting and/or finance qualification	0.833	86.119	0.856	87.578
Committee meeting frequency	0.694	100.000	0.621	100.000

	CC	RC
Panel C: Correlations between the common factor and five committee efficacy measures		
Factor score	1	1
Committee independence	0.669***	−0.284***
Proportion of committee directors with 10 or more years experience in the financial industry	0.003	−0.116*
Proportion of committee directors with 10 or more years experience on the board	−0.466***	−0.338***
Proportion of committee directors with an accounting and/or finance qualification	−0.087	0.257***
Committee meeting frequency	0.756***	0.877***

** $p < 0.05$.
* $p < 0.10$.
*** $p < 0.01$.

The beta coefficient, with a mean of 1.27, suggests that financial firms faced a significant amount of market risk over the years 2006-2008. The average score for the standard deviation of monthly returns (STD.DEV) for the entire sample of 711 observations is 10.60, indicating a significant level of variability in returns for financial organizations. The compensation committee is typically composed of an average of 3.20 members. The CC has a 75% proportion of independent directors. Among the sample, 22% have at least one director with a board experience of 10 or more years, and 73% of the CC members have at least 10 years of industry service. On average, 28% of the CC members possess either accounting or finance professional qualifications. The mean number of CC meetings between 2006 and 2008 is 2.91, and 6% of CEOs were members of the CC committee in the sample. The average membership of the risk committee is 3.61. The majority (80%) of the members of the RC are independent directors. The number is 15. More than 75% of RC members had over a decade of experience in the sector, and 13% of members have served on the board for at least 10 years. Typically, 32% of RC members has professional qualifications in accounting and/or finance. The mean number of RC meetings per year is 4.75. Sixteen Just 3.50% of the RC observations indicate that the CEO is present on the RC. Out of the 185 instances when both an RC (Review Committee) and a CC (Control Committee) are present, 26% of them involve a member who serves on both committees.

4. Conclusions

This study sheds light on the significance of corporate governance processes and risk management in Australian financial organizations. Within the framework of agency theory, corporations have the motivation to implement corporate governance measures, such as board committees. This is because shareholders are unable to directly oversee the conduct of managers. This study examines Australian enterprises in the financial sector from 2006 to 2008 and presents evidence supporting the significance of committees in enhancing corporate performance by controlling risk. The results of this study indicate the importance of having compensation and risk committees with members who are autonomous from management, possess industry and board expertise, are professionally qualified, and convene regularly. Significantly, this study reveals that when committee members simultaneously serve on both the risk committee and the remuneration committee, the firm's level of risk exposure is scrutinized more diligently, resulting in a favorable correlation between risk and performance. This finding indicates that coordination and communication issues are reduced when committee members' duties go beyond specific tasks. Further investigation of this finding could be conducted in future studies by conducting interviews with members of risk and compensation committees.

This study is the inaugural investigation of the correlation between corporate governance controls, specifically pay and risk committees, and risk management in Australian financial institutions. The study has practical applications as it shows the advantages of coordinating the functions of monitoring committees. Being a member of two committees simultaneously has a beneficial effect on both risk management and performance. This can help prevent compensation committees from unintentionally creating compensation plans that encourage excessive risk-taking and result in subpar performance.

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