Evaluating the Role of Executive Management in Risk Governance Perspective: A Case of Banking Industry of Pakistan

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Abstract

The purpose of this research is to evaluate the role of the Executive Risk Management Committees (ERMCs) in the risk management framework for the banking industry of Pakistan. Qualitative approach was used to address the research question of this study. In depth interviews were conducted from the CROs/Heads of Risk, Heads of Market Risk and Heads of Credit Risk of commercial banks of Pakistan. The results of the study show that the involvement of Asset-Liability Committee and Credit Risk Committee is very crucial in each phase of the risk management process. Moreover, the results show that the critical oversight of the market & Liquidity risk management process stages e.g. identification, assessment, monitoring & controlling is done by the ALCO. The study recommends that the ERMCs (ALCO and CRC) should analyze the projects using a holistic view of risk rather a silo view so that each committee can incorporate the effects of all kind of risks inherent in the projects and can give a better evaluation of the proposals to the BRMC.

Introduction

The risk management program in any organization is not successful without the support of executive management (Kleffner et al., 2003; Barton et al., 2002). The ultimate burden of risk management is on the shoulders of BoDs. Hence, ERM programs are initiated within the organization to safeguard the organizational assets. The risk management programs also required the support of executive management for the structuring and fostering of risk culture, effective allocation of resources which help out in the ERM implementation. According to the study of Beasley et al. (2005), the executive management support has a positive impact on the level of ERM implementation thus plays a vital role in the implementation risk management programs in the organizations. It is evident from the available researches that the performance of commercial banks is largely dependent on the implementation of risk management. One

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such study was Fernando and Nimal (2014) which gave empirical evidence that the efficiency of Sri Lankan commercial banks has improved through the adoption of risk management. In the same way, a strong positive relationship was highlighted between risk management practice and performance of the commercial banks in Malaysia (Ariffin & Kassim, 2011). Correspondingly, the study of Oluwafemi et al. (2013) proved a significant relationship between risk management and performance in Nigerian commercial banks. There is a dearth of literature on the role of top management in the implementation of risk management framework and no study is available on this issue in the local context. Therefore, present study fills this gap by exploring the role of executive management in the implementation of risk management framework for banking industry of Pakistan in risk governance perspective.

Research Question

1. How effective is the role of top management through its Executive Risk Management Committees (ERMCs) in the strengthening of risk management framework of banking industry of Pakistan?

Research Objective

1. To explore the risk governance issues in the proper functioning of Credit Risk Committee (CRC) in risk management framework for the banking industry of Pakistan.
2. To explore the risk governance issues in the proper functioning of Asset-Liability Committee (ALCO) in risk management framework for the banking industry of Pakistan.

Literature Review

It is evident from the previous studies that the commitment, knowledge, capabilities and support of the executive management are crucial factors for the success of ERM programs (Adams, 2010; Bowling & Rieger, 2005). The moderating role of executive management support is evident between ERM practices and banking performance (Aebi et al., 2012). A study of Manab and Kassim (2012) demonstrated the moderating role of leadership between the implementation of ERM and level of RM practices in Malaysia. According to the study of Dabari and Saidin (2014), the executive management support played a moderating role between the antecedents and level of ERM implementation in Nigeria. For the success of the risk management programs, the tone of the risk management must be set at the top. According to SBP (2003), the BoDs are having the ultimate responsibility of the risk management but the executive management must translate the vision of the BoDs regarding risk management into guidelines, policies and written procedures in order to develop a sound hierarchy for the implementation of those policies in true letter and spirit. The clarity and communication of RM policies are very essential from top to bottom. SBP (2003) clearly stated in the risk management guidelines that it is the responsibility of the executive management to fuse these policies into the organizational risk culture. The top management must communicate the risk tolerance of quantifiable risks in the form of risk limits to the risk personnel. Whereas, the communication of non-quantifiable risks is done through written guidelines and management business decisions.

The executives of the institutions mostly relied on the bottom-up risk management while failed to provide adequate strategic direction from top to bottom. The real question is who should lead the risk management strategic position? This role is certainly not belonged to risk function or risk managers. This role should be with the BoDs and executive management who should have adequate risk management experience and knowledge to facilitate them in better decision making. The executives of the C-Suit in collaboration with CRO are responsible for the defining and setting of risk appetite for the institution. This can be accomplished with ease if the members of the executive management have an in-depth understanding their risk profile (Ded Rach Whitepaper, 10 Oct 2016).

Methodology

Population and Sample

The interviews were conducted from the 23 CROs/Heads, Head of Market Risk and Head of Credit Risk as these personnel are members of ERMCs (i.e. CRC and ALCO) in commercial banks of Pakistan. As there are 23 commercial banks in Pakistan and each bank has only one position of CRO/Head of Risk, Head of Market and Head of Credit Risk, therefore present study took the full population for the interviews. Moreover, there is no need to take a sample from the population. In total 69 interviews were conducted.

Interview Script Sheet

The interview script sheet was prepared during the preliminary interview with three CROs, two Heads of Market Risk and two Heads of Credit Risk. Initially there were 12 questions in the interview script sheet which were reduced to 9 questions after consultation with the above-mentioned risk experts.

Thematic Analysis

The primary method that is used in the qualitative studies to explore the various aspects of the phenomenon is Thematic Analysis (Braun & Clarke, 2006). The thematic analysis started with the coding stage in which the responses (coded extracts) related to a certain concept were arranged and organized under a single node. In the same way other coded extracts relating to a second concept were arranged and organized under another node. This process continued until all the relevant information of the interviews were arranged and organized under related nodes. After the completion of the coding process, the theme generation stage started. In theme generation stage, themes were extracted which were addressing the research question and research objectives of the study. The word cloud analysis was used to generate the initial themes then the theme refinement stage was done using word tree analysis. In theme refinement stage, some themes were merged into one theme as they were depicting the similar concept. Moreover, some themes segregated into two sub themes as they were depicting two sub concepts. The qualitative analysis was done using QSR Nvivo 11.

Result and Findings

The next section explains the thematic analysis using the word cloud and world tree analysis in the following section.

Word Cloud Analysis

The word cloud mentioned in figure 1 shows the themes related to the role of executive management in risk management in the banks. This word cloud is helpful in extracting the potential themes in the data collected through interviews. The potential themes from the word cloud are 'ERMC', 'oversight', 'ALCO', 'CRC', 'approval', 'mechanism', 'market','credit', 'liquidity', 'limits', 'design', 'evaluation' etc. The refinement of these potential themes is done through context analysis using tree analysis which is to be discussed in later section.

Word Tree Analysis

The theme generated from the codes is the *effectiveness of Asset & Liability Committee (ALCO)*. Now the next section and figure 2 will explain how this study brought up to this theme from the initial codes. The market and liquidity risk are monitored at every stage of risk management process by the asset and liability committee (ALCO) in Pakistani commercial banks under the supervision of board risk management committee (BRMC). The market and liquidity risk management policies are designed and developed by the ALCO keeping in view the market and liquidity risk appetite of the bank. During the interviews, several interviewees highlighted the importance of ALCO in risk management as follows:

[*In the risk management, ALCO is responsible for management of market and liquidity risk. The development and revision of appropriate risk management policies and procedures are the responsibility of the ALCO.*]

[*The Bank has ALCO in place for the establishment of effective internal controls for monitoring & controlling of liquidity and market risks.*]

[*The ALCO is appointed and authorized by the Board of Directors (BoDs) to assist in the designing, regular evaluation and timely updating of the market & liquidity risk management framework of the Bank.*]

For the effectiveness of the ALCO, several interviewees point out the need for experienced market and liquidity professionals in the ALCO. Without the relevant market and liquidity risk experience the members are unable to identify, access and monitor the foreign exchange,

interest rate, equity price and liquidity risk in the banking transactions and products. Furthermore, BoDs gives the strategic direction for market and liquidity risk management

while the implementation of market and liquidity risk lies with ALCO. The designing of written procedures and processes is the responsibility of ALCO. Therefore, ALCO members should design and develop these policies very delicately and with great care. Arguments made by interviewees in this regard are given below:

[*The ALCO members should have relevant experience in market and liquidity risk and clear understanding of the nature and level of market and liquidity risk assumed by the bank.*]

[*To manage and maintain effective Risk Management practices, the ALCO plays a pivotal role by integrating the efforts of the banking risk force. The critical oversight of the market & Liquidity risk management process stages e.g. identification, assessment, monitoring & controlling is done by the ALCO.*]

[*The Board of Directors (BoDs) gives the strategic direction for market & Liquidity risk management for the bank but the ALCO translate those directions into written procedures for the market & liquidity risk management so the vision of risk management is delineated to deep down in the bank.*]

The risk management standards and guidelines are kept on changing due to changing business environment and financial crisis. The bank of international settlement (BIS) updates the risk management guidelines and standards according to the changing business environment. The state bank of Pakistan (SBP) responds to these changes and adopt these new standards and issues its own guidelines according to Pakistan's commercial banking industry needs. The banks operating in Pakistan are bound to adopt these guidelines. Therefore, ALCO of these banks is responsible for making details procedures and processes to implement those guidelines. During the interviews, almost all the interviewees point out the role of ALCO in the adoption of risk management guidelines issued by SBP and also asserts the need to make ALCO effective to avoid huge losses. Their views are given below:

[*The SBP issues guidelines for various types of banking market & liquidity risks from time to time basis. The ALCO oversees these guidelines and put in its efforts to conform the banking market & liquidity risk management practices to those of SBP guidelines.*]

[*The ALCO plays an important role in assigning responsibilities and roles in the management of market & liquidity risk in the risk management function. The role of ALCO is so vital that without the ALCO's oversight the bank would incur huge losses in the domain of market & liquidity risk domain.*]

[*The market & liquidity risk management process is strengthened by the ALCO through optimum operating procedures and policy documents so that the market & liquidity function effectively take guidelines from these procedures.*]

The next theme generated from the codes is the *effectiveness of Credit Risk Committee (CRC)*. Now the next section and figure 3 will explain how this study brought up to this theme from the initial codes.

The BRMC oversight the credit risk through an executive risk management committee known as Credit Risk Committee (CRC). The CRC take directions from the BRMC and accordingly set the policies and procedures. The implementation of those policies is also on the shoulders of the CRC. The credit risk management process is handled by the CRC at each and every phase i.e. identification, assessment, monitoring & controlling. The CRC plans according to the credit risk appetite set by the BoDs. During the interviews, almost all the interviewees highlight the role of CRC in credit risk management within banks. Some of their views are as follows:

[*In the risk management, CRC transforms the directions given by BRMC into procedural guidelines and policy documents relating to credit risk. Furthermore, the implementation of those policies is done by the CRC.*]

[*To manage and maintain effective risk management practices, the CRC plays a pivotal role by integrating the efforts of the banking risk force. The critical oversight of the credit risk management process stages e.g. identification, assessment, monitoring & controlling is done by the CRC.*]

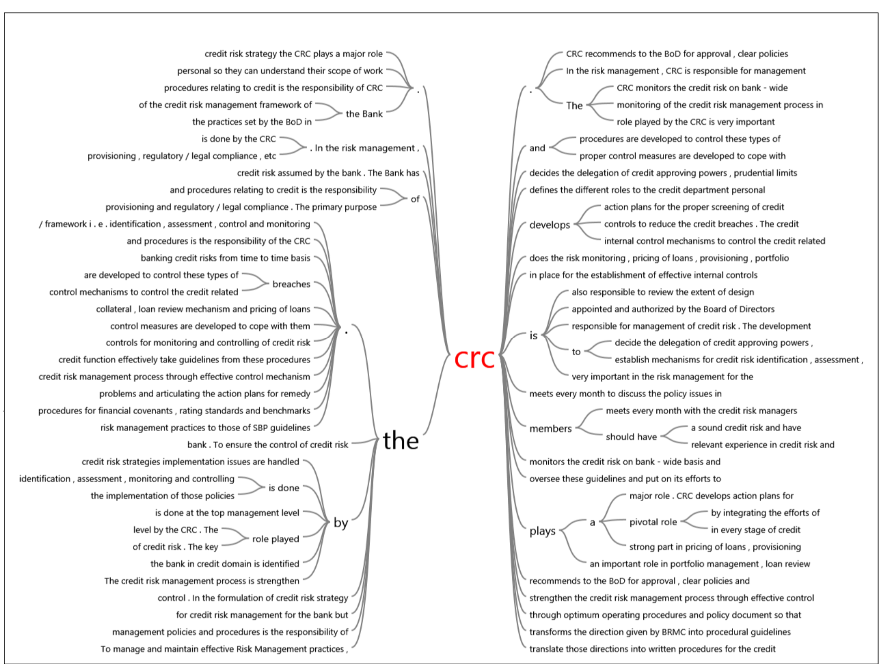

Figure 3: Word Tree Analysis on Role of CRC

[*The monitoring of the credit risk management process in all stages (identification, assessment, controlling, monitoring) is done at the top management level by the CRC. The role played by the CRC is very important in the risk management for the effective implementation of the practices set by the BoDs in the bank.*]

The credit risk management is heavily dependent on the effectiveness of the credit risk committee (CRC). Therefore, the effectiveness of the members is very vital for the smooth functioning of the CRC. The members of the CRC should have adequate credit risk experience and exposure so that they dealt well with the credit risk related issues. During the interviews, several interviewees point out the importance of effectiveness of CRC in credit risk management. Some of their views are as follows:

[*The CRC members should have relevant experience in credit risk and clear understanding of the nature and level of credit risk assumed by the bank.*]

[*The CRC members should have a sound credit risk and have a good understanding of the credit risk assumed by the bank. To ensure the controlling of credit risk the CRC members meet every month with the credit risk managers and strategy planners. The credit risk strategy implementation issues are handled by the CRC and procedures are developed to control these types of breaches.*]

The purpose of appointment of CRC is to help out the BoDs and BRMC in designing the credit risk management framework. Furthermore, it assists in evaluating the risk management framework and keeps on updating the framework when required. Moreover, the CRC assists the BRMC in deciding the prudential limits on massive loans. The CRC defines the roles of various personnel in credit risk department so that they can understand their role and its scope. During the interviews, several interviewees give their views about the responsibilities of the CRC in effective credit risk management in banks. Some of their views are as follows:

[*The CRC is appointed and authorized by the Board of Directors (BoDs) to assist in the designing, regular evaluation and timely updating of the credit risk management framework of the Bank.*]

[*The CRC decides the delegation of credit approving powers, prudential limits on large credit exposures and standards for loan collateral.*]
[*The CRC defines the different roles to the credit department personnel so they can understand their scope of work. CRC develops controls to reduce the credit breaches.*]

Conclusion

It is concluded from the results that the role of top management is very important in the strengthening of risk management framework for the banking industry of Pakistan. The risk assistance of top management to the BRMC is very vital for better decision making. Moreover, there is a need of efforts for developing a strong risk culture in the banks so that every person in the bank look at anything with a risk lens. It is also concluded that the change of mindset is required within the top management towards the risk management function as they perceived risk management function as a hurdle to their progress. The role of CRC and ALCO committee in setting up various risk limits and risk appetite is very crucial. It is concluded that if ALCO and CRC paly their part in full capacity and care then this will result in development of strong risk management framework for banks. The ERMCs (ALCO and CRC) should analyze the projects using a holistic view of risk rather a silo view so that each committee can incorporate the effects of all kind of risks inherent in the projects and can give a better evaluation of the proposals to the BRMC.

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