The utility of corporate governance in managing financial risks in banks -case study of a local bank-

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Abstract:

This article provides a comprehensive overview of topics focusing on corporate governance and the assessment, analysis, and management of financial risks in banking. It emphasizes risk management principles and stresses that key players in the corporate governance process are accountable for managing the different dimensions of financial and other risks. In this sense, the first section presents a review of literature concerning the concept of corporate governance and financial risks management. The second section will be dedicated to the empirical study, from which we have learnt that there is a significant importance of corporate governance in enhancing financial risks management in banks.

Keywords: Corporate governance, financial risks, banks.

JEL classification codes: G32, G34.

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Introduction:

Succeeding the economic breakdowns and financial crises that several countries have witnessed in the past few decades, which were triggered by financial and administrative corruption, immoral abuses, and weak laws and legislations, attention has increased to the necessity of a rational and effective system of governance that works on the basis of the principles of transparency, accountability and protection the rights of stakeholders, and giving them the opportunity to participate in the making and decision making of the company. In addition to the popularity of huge investments that require separation of ownership from management, and consequently the emergence of agency problems and conflict of interests of stakeholders, this means the need for a law for the relationship between them, as it protects the interests of shareholders from manipulation and fraud of executives. In general, every economic institution aims to maximize its returns, which leads to higher financial risks as well, and therefore it must balance between returns and risk by forecasting risks, identifying them, measuring them, and determining the best way to deal with them (avoid them, control them or transferred them to another party), this is done through an effective financial risks management system. It is also believed that compliance with the application of corporate governance rules affects the effectiveness of financial risks management in general. An empirical study will take place in the Algerian National Bank BNA of Oum El bouaghi.

In this sense the study attempts to find responses to the next questions:

- To what extent does the appliance of corporate governance principles affect the effectiveness of managing financial risks in banks?
- To what extent are the principles of corporate governance applied in the BNA bank, of Oum el bouaghi?
- What is the importance of corporate governance?

Study hypotheses:

- The commitment to apply the principles of corporate governance positively affects the effectiveness of managing financial risks in banks.
- The principles of corporate governance are reasonably applied in the BNA bank of Oum elbouaghi ;
- The importance of corporate governance is to achieve strategic goals;

I. Literatures review

1. Corporate governance

The interest in corporate governance has increased in the past few years locally and internationally, due to its contribution to enhancing confidence in the economy of any country, and ensuring the integrity of transactions, governance is considered as a fundamental key to increasing profits and raising the market value, and reduce risks.

1.1 Origins of corporate governance

Both Means and Berle were considered the first to address the issue of corporate governance and the separation of ownership from management, and some believe that corporate governance dates back to Adam Smith in the eighteenth century, where he called in the establishment's theory of the necessity to establish laws for the relationship between owners and agents (Executive management), and corporate governance principles have been put in place to fill the gap that may occur between the company's owners and agents due to negative practices that may harm the company. The United States of America was the first in this field, as the New York Stock Exchange (NYSE) proposed rules requiring companies to appoint independent directors to attend the board of directors, as well as the formation of a Corporate risk follow-up Committee to periodically review potential risks. As for Japan, the Tokyo Stock Exchange has developed a good governance to guide Japanese companies. As for the European Commission, it has assigned a working group to develop and standardize the legal framework for companies with the aim of disclosure and protection of investors. (Khayra, 2016, p. 48)

1.2 Reasons and motives for the emergence of corporate governance:

- **Agency theory and the problems it causes:**

This theory is based on the principle of separating ownership from management for several reasons, including the large size of the companies, and the lack of competence and experience of the owners compared to specialized agents. (Makhlouf, 2016, p. 87)

This theory has led to great problems and conflict between the interests of the various parties, and therefore it is necessary to establish laws that work to protect the interests of shareholders, and to limit financial and administrative manipulation that may be performed by members of the board of directors in order to maximize their own interests as they are the party that holds the reins of affairs.

- **Cases of fraud, bankruptcy and major financial breakdowns:**

The financial collapses in many international companies, such as Enron, World Com, Barings Bank, have reflected the need to implement governance rules to restore financial and administrative balance and address the imbalance in corporate organizational structures.

- **Financial crises:**

The financial crises resulting from financial and administrative corruption have weakened the performance of institutions, and made it difficult to attract the necessary capital, which led to heavy financial losses. Consequently, the importance and necessity of protecting investors from the mistakes of corporate boards of directors emerges, by setting up a rational system of governance, adhering to strict regulatory procedures, and focusing on transparency in dealing between stakeholders.

- **Globalization**:

Globalization and the liberalization of financial markets and the transformation of many countries of the world to the concept of a free economy have led to the separation of ownership from management due to the increase in the size of institutions, and as a result of the above, the necessity of seeking new control systems and mechanisms has emerged to ensure the protection of the rights of all stakeholders in the institutions

1.3 Definition of corporate governance

Corporate governance is a process that aims to allocate corporate resources in a manner that maximizes value for all stakeholders – shareholders, investors, employees, customers, suppliers, environment and the community at large and holds those at the helms to account by evaluating their decisions on transparency, inclusivity, equity and responsibility". (Raut, p. 1)

Corporate Governance refers to the way in which companies are governed and to what purpose. It identifies who has power and accountability, and who makes decisions. It is, in essence, a toolkit that enables management and the board to deal more effectively with the challenges of running a company. Corporate governance ensures that businesses have appropriate decision-making processes and controls in place so that the interests of all stakeholders (shareholders, employees, suppliers, customers and the community) are balanced.

1.4. Principles of corporate governance (OECD, 2015, pp. 1-45)

Due to the great importance of corporate governance, many international organizations have been interested in issuing international principles for good governance in financial and banking institutions, the principles issued by the Organization for Economic Cooperation and Development are the following:

- **Ensuring the basis for an effective corporate governance framework:**

Corporate governance framework should promote transparency, fair markets, and effective allocation of resources, be consistent with the rule of law and support effective oversight and enforcement.

The corporate governance framework should be developed with aim of influencing overall economic performance, market integrity and the incentives it provides to market participants and promoting well-functioning and transparent markets. Legal and regulatory requirements that affecting corporate governance practices must be consistent with the rule of law, transparent and enforceable. The division of responsibilities for the different authorities should be clear and designed to serve the public interest. Stock market regulation should support effective corporate governance. Supervisory, regulatory and enforcement authorities must have the authority, integrity and resources to fulfil their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained.

- **The rights and equitable treatment of shareholders and key ownership functions:**

Corporate governance framework should protect and facilitate the exercise of shareholders' rights and ensure their fair treatment, including minority and foreign shareholders. All shareholders must have the opportunity to obtain effective compensation if their rights are violated.

- **Institutional investors, stock markets, and other intermediaries:**

corporate governance framework should provide sound incentives at all stages of the investment chain and provide for stock markets to function in a way that contributes to good corporate governance.

The applicable corporate governance laws and regulations must be disclosed clearly. Institutional investors must disclosure their corporate governance policies and voting policies in relation to their investments.

They must also disclosure how they manage material conflicts of interest that may affect the exercise of property rights in relation to their investments.

The corporate governance framework requires advisors and analysts.

Brokers who provide analysis and advice related to investor decisions disclose conflict of interests and try to reduce them.

- **The role of stakeholders in corporate governance:**

-The corporate governance framework must recognize and respect the rights of stakeholders;

- Stakeholders should have the opportunity to obtain effective compensation in case their rights are violated, (Phoon, 2019, p. 5)

-The participation of stakeholders in the management of the company should be allowed;

-The corporate governance framework should encourage active collaboration between stakeholders and companies to create rich business opportunities and corporate sustainability.

- **Disclosure and transparency :**

The role of disclosure is reducing information asymmetry between insiders (management or majority shareholders) and outsiders (minority shareholders, creditors, and other stakeholders). Good corporate governance includes a vigilant board of directors, timely and adequate disclosure of financial information, meaningful disclosure about the board and management process, and a transparent ownership structure identifying any conflicts of interests between managers, directors, shareholders, and other related parties (A. Patel, G. Dallas,2002,p.5)

A. Disclosure should include, but not be limited to, material information on:

- The financial and operating results of the company;

-Company goals and non-financial information;

- Ownership of major shares, including beneficial owners, and voting rights;

- Remuneration of board members and senior executives;

- Information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board;

- Transactions of with related parties;
- Expected risk factors;
- Issues related to employees and other stakeholders

B. Information must be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial reporting;

C. A high-quality annual audit must be performed by a qualified auditor to provide external confirmation to the board of directors and shareholders about the status of the company and that the financial statements represent the financial position and its performance;

D. External auditors must exercise due professional care in conducting the audit.

- **The responsibilities of the board:**

The corporate governance framework must ensure the strategic direction of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders. Board members must act on the basis of full knowledge, in good faith, with due care and diligence, and in the interest of the company and the shareholders. Where board decisions may affect different shareholders groups differently, the board of directors must treat all shareholders fairly. The board of directors must apply high ethical standard, and it must take into account the interests of the stakeholders.

2. Financial risks

2.1 Definition of Financial risks

Risks is the probability of loss resulting from certain events, such as a change in market prices, events with a low probability of occurrence but may lead to large losses; in short, risk is the potential variability of returns. Since it is not always possible to eliminate financial risks, understanding it is an important step in determining how to formulate an appropriate strategy to manage it. (Horcher, 2005, p. 2)

2.2 Sources of Financial risks

Financial risks arise through a large number of financial transactions, which we classify below:

. Financial risks arising from institution's exposure to changes in market prices, such as interest rates, exchange rates, and commodity prices;

. Financial risks arising from the procedures and transactions with other organizations such as vendors, customers, and counterparties
in derivatives transactions.

. Financial risks resulting from internal actions or failures of the organization, particularly people, processes, and systems.

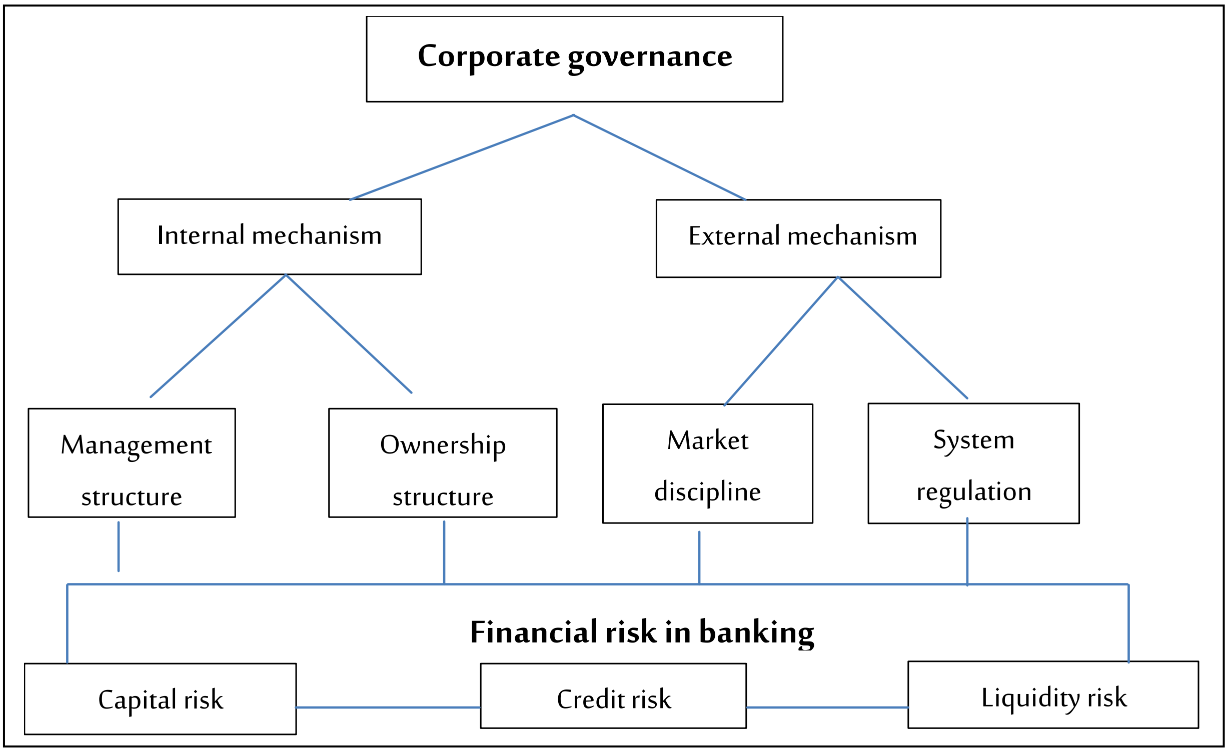
2.3 risks management

2.3.1 Definition of risks management

Generally, financial risks management is the set of processes by which management identifies, analyses, and where necessary responds appropriately to risks that might adversely affect achievement of the organization's business objectives. The response to risks usually depends on their perceived gravity, and involves controlling, avoiding, accepting or transferring them to a third party. While organizations routinely manage a wide range of risks (e.g. technological risks, commercial/financial risks, information security risks etc.), (Raut, p. 9) financial risks management is more than just an action; it is a continuous and vigilant activity, the goal of which is not only to avoid losses, but to achieve target financial goals and results. Financial risks arises when there is a possibility of more than one result, and although all. businesses face risks, but financial institutions face some types of special risks due to the nature of their activities. (EID, 2012, p. 80) Based on the above, financial risks management is a continuous process and requires vigilance, in which the expected financial risks are predicted, then analysed, evaluated, and determined their size and impact, and finally how to deal with them (avoid them, accept them, manage them or transfer them to another party) to reduce its negative effects on the institutions.

2.3.2 **The relationship between corporate governance and Financial risks in banks:** The link between corporate governance and financial risk is illustrated in the figure below:

Figure: Relationship between corporate governance and financial risk



Source: (Trinh, 2015)

The figure shows tne mecnanisms or corporate governance, the rules and regulations in banks have been classified as external mechanism, and internal mechanism is about accountability, monitoring, and controlling of firm's management with respect to the use of resources and risk taking. Since bank financial risks contains capital risks, credit risks, and liquidity risks, these financial indicators are used as dependent variables in the model.

Capital: plays an important role, and it is the biggest concern for the shareholders, therefore, managers must ensure that the minimum capital adequacy ratio is maintained, as well as use international financial risks management methods and programs in forecasting, assessing and managing risks effectively.

Board size: has impact on supervision, management and consultation capacities of managers. Some researchers believe that a smaller board size works more effective since a larger board will encounter more difficulties when supervising managers. However, some suggest that a larger board size will strengthen capacity to supervise and improve information sources A larger board consists of more number of directors who work towards the interest of the stakeholders in monitoring and controlling, and thereby increasing the firm performance (K. Anjala,SM. Shrivastav,2016).

Board composition: indicates a proportion of non-executive board members that contributes an objective view in consultation and making decision process of the board. An overwhelmed percentage of non-executive board members could spoil the consultation roles of the board since it may prevent the executives from participating the board which then leads to the difficulties in transferring the information between the board and the executives.

Audit committee: may have impact on the risk level of company to a noticeable degree. Because one of main responsibilities of audit committee is supervise the integrity of financial statements, internal auditing and financial risks management.

Ownership structure: is also a critical determinant of corporate governance. (S. Mollah et al 2012) Capital structure relates to foreign capital, state-owned capital, majority shareholders. Consequently, capital proportion of foreign investors may represent for an ownership factor of internal governance.

System regulation: plays central roles, in which information disclosure regulation is one of the challenges in corporate governance. Being a bridge between the bank and related authorities, the board is responsible for disclosing information transparently to shareholders, authorities and other stakeholders. This is compulsory for large and listed companies in banking industry.

Market discipline*:*

Market discipline involves two distinct components the ability of market participants to accurately assess the condition of a firm (monitoring) and their ability to impact management action in a way that reflects that assessment ,influencing (MARTIN ELING,2011) .Market discipline mentions about roles of depositors and shareholders in punishing the bank for unacceptable risks. Specifically, depositors can withdraw their money or require a higher interest rate to compensate for a higher risk. Shareholders can sell their shares and push the price down. Then, when the bank can realize a situation of higher funding cost or high withdrawing deposit can endanger their existences, they will avoid involving in too high risk activities and conduct safety management.

II. Empirical study

This part is a link between the two variables corporate governance and financial risks, by studying the opinions of a sample of employees of the Algerian National Bank BNA in Oum El Bouaghi district.

1. Study Sample: the sample includes 30 valid responses.

2. Study reliability:

Cronbach's alpha is the most common measure of internal consistency (reliability). It is most commonly used when we have multiple Likert questions in a questionnaire. it tells us if the scale is reliable.

A - Cronbach's alpha of the independent variable (applying corporate governance) which is composed of ten items.

Table 1: Reliability Statistics (SPSS Output)

Reliability Statistics	
Cronbach's Alpha	***N of Items***
.766	10

Source: (SPSS Output)

The alpha coefficient for the ten items is .766 suggesting that the items have relatively high internal consistency. (Note that a reliability coefficient of .70 or higher is considered "acceptable".

B - Cronbach's alpha of the dependent variable (Financial risks) which is composed of ten items.

Table 2: Reliability Statistics (SPSS Output)

Reliability Statistics	
Cronbach's Alpha	***N of Items***
.701	10

Source: (SPSS Output)

The alpha coefficient for the ten items is .701 signifying that the items have relatively high internal consistency.

3. Descriptive analysis of the variables' sentences:

3.1 Analysis of the independent variable (The extent of applying corporate governance in the bank).

Table 3: Corporate governance sentences:

	Statement	Average	Std dev.	Tendancy
Q1	Laws and rules are developed to suit the objectives of the bank.	4.25	0.846	Strongly Agree
Q2	The banks activities are subject to internal and external controls	4	0.780	Agree
Q3	Governance aims to protect their rights of shareholders	3.79	0.779	Agree
Q4	The board of managers takes into account the equal and fair treatment of shareholders, and their obtainment of actual compensation in case of violation of their rights.	3.79	0.658	Agree
Q5	Shareholders have the right to participate in voting in the general meeting.	3.87	0.850	Agree
Q6	Corporate governance framework works to ensure that the rights of stakeholders as stipulated by law are respected.	4.08	0.653	Agree
Q7	The bank provides the necessary information to	3.79	1.020	Agree

	stakeholders on a regular and timely basis.			
Q8	The bank carries out the annual review process with the assistance of an independent auditor.	3.75	0.794	Agree
Q9	The bank discloses accurately and in a timely manner all matters related to the financial position, performance, ownership and style of exercising authority.	3.92	1.059	Agree
Q10	The bank has channels that allow its users to obtain information in a timely manner and at the right cost.	3.67	0.815	Agree

Source: (SPSS Output)

The respondents agreed about the appliance of corporate governance in their company with a medium between 3.67 for the last sentence, and 4.25 for the first sentence.

3.2 Analysis of the dependent variable (risks management in Banks)

Table 4: Financial risks sentences

	Statement	Average	Std. dev.	Tendancy
Q1	Financial risks management aims to reduce losses, stabilize profits, and achieve growth and sustainability.	4.29	0.806	Strongly Agree
Q2	The bank adheres to international standards related to Financial risks management.	4.63	0.575	Strongly Agree
Q3	The bank is committed to allocate the necessary capital reserve to face various business uncertainties.	3.83	0.701	Agree
Q4	The bank coordinates all its departments to ensure availability of data on risks.	4.13	0.991	Agree
Q5	The bank has the intention to appoint an independent and specialized committee to manage business uncertainties.	4.17	0.701	Agree
Q6	The financial risks management committee formulate as a clear strategy to manage and monitor financial risks.	4.21	0.588	Strongly Agree
Q7	The decisions and opinions of the board of directors, account auditors and bank managers are used in setting risks management systems and strategies.	3.83	0.963	Agree
Q8	It is verified by the board of directors that all risks have been managed properly.	4.33	0.701	Strongly Agree
Q9	A report of financial risks is prepared and presented to the board of directors and stakeholders	3.92	0.880	Agree
Q10	Regulatory controls are in place to ensure compliance with laws	3.92	0.928	Agree

Source: (SPSS Output)

All the ten statements were approved with a medium between 3.83 and 4.63, This indicates that the bank manages fairly financial risks.

3.3 Correlation and linear regression between variables:

Pearson's correlation is a measure of the strength and direction of association that exists between two variables measured on at least an interval scale. Regression measures to what extent corporate governance application influences risks management in banks through calculating the value of R square.

Table 5: Correlations and linear regression between corporate governance application and risks management

Table:5 Correlation and linear regression between variables, (SPSS Output).

Model	R	R square	R square adjusted	Std. Error of estimation
1	0.629 [a]	0.395	0.380	0.21814
a. Predictors: (Constant), the extent of applying Governance Dependent variable: risks management				

The table shows a positive relationship between corporate governance and risks management.

The value of Pearson's correlation coefficient R is 0.629, which reflects a strong relationship between the appliance of corporate governance and risks management.

The value of R square is 0.395, that represents the proportion of the variance for a dependent variable that's explained by an independent variable. this means that 39.5 % of risks is managed by the appliance of corporate governance.

Subsequently, the study model has been approved i.e. The appliance of corporate governance principles effectively enhances risks management in corporations.

III. Conclusion

The appliance of corporate governance principles in banks is crucial because of its importance in increasing the effectiveness of risks management in institutions, helping them to attract capital easily, in addition to the ability to compete and raise their market value. The commitment to applying the principles of corporate governance has shown clear results and vast differences in increasing the effectiveness of financial risks management,

Based on the empirical study :

- There is a positive relationship between the application of corporate governance and financial risks management, and this confirms the main hypothesis.
- The importance of corporate governance lies in the effective management of the institution's affairs, to ensure the achievement of the established goals of all stakeholders.

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