RISK MANAGEMENT IN THE NIGERIAN BANKING INDUSTRY

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Abstract

Risk Management is the identification, assessment, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events .It introduces the idea that the likelihood of an event happening can be reduced, or its consequences minimized. The banking industry is a highly regulated industry with detailed and focused regulators. This is because of the risks associated with it. And these risks, if not properly assessed and prioritized, time can be wasted in dealing with it. At the same time, spending too much time assessing and managing unlikely risks can divert resources that could be used more profitably. This paper discussed the recent development in the Nigeria banking industry and also out lined the Risk factors in the Banking industry and some principles/steps used in handling them. Also highlighted are some software used in managing Risk in the Banking industry.

INTRODUCTION

In today's world, managing risk has become a necessity, not an option. Sanusi,(2010) pointed out that in recent years excessive credits and financial asset growth went unchecked. Risk, in insurance terms, is the possibility of a loss or other adverse event that has the potential to interfere with an organization's ability to fulfill its mandate, and for which an insurance claim may be submitted.

The current CBN Governor (Sanusi) sanitization in the banking industry revealed the holes in the Nigerian banking industry, especially on the recklessness of the bank chief executives. But before that, the former CBN Governor Soludo (2004) made it known in one of his speeches that Nigerian banking system today is fragile and marginal.

Commercial banks are in the risk business. In the process of providing financial services, they assume various kinds of financial risks Anthony (2009). On 22nd july 2008, The Basel Committee on Banking Supervision issued for public comment Guidelines for Computing Capital for Incremental Risk in the Trading Book as well as Proposed Revisions to the Basel II market risk framework. In Basel II, risk management is divided into credit, market and operational risk management. In many cases, credit and market risks are handled through a company's financial department, whereas operational risk management is through a company's coordinated centrally but most commonly implemented in different operational units.

What is Risk Management?

Risk management introduces the idea that the likelihood of an event happening can be reduced, or its consequences minimized. Effective risk management seeks to maximize the benefits of a risk (usually a reduction in time or cost) while minimizing the risk itself.

Risk management is the process of identifying risks, assessing their implications, deciding on a course of action, and evaluating the results. wikipedia . Risk Management is the identification, assessment, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events. Risks can come from uncertainty in financial markets, project failures, legal liabilities, credit risk, accidents, natural causes and disasters as well as deliberate attacks from an adversary. Risk management ensures that an organization identifies and understands the risks to which it is exposed.

RISK MANAGEMENT I N THE BANK

The banking industry is a highly regulated industry with detailed and focused regulators.

While banks struggle to keep up with the changes in the regulatory environment, regulators struggle to manage their workload and effectively regulate their banks. The impact of these changes is that banks are receiving less hands-on assessment by the regulators, less time spent with each institution, and the potential for more problems slipping through the cracks, potentially resulting in an overall increase in bank failures. Jaiye (2009) mention in his paper that the business of Banking is to manage risks associated with accepting deposits, granting loans and trading portfolios. The changing economic environment has a significant impact on banks and thrifts as they struggle to effectively manage their interest rate spread in the face of low rates on loans, competition for deposits and the general market changes, industry trends and economic fluctuations. Andrea (2010) in his study mentioned that Management failure can be easily recognized in losses resulting from over-aggressive lending practices and risk tolerances that were too high. However, as one digs deeper, more subtle failures can be recognized in operational inefficiencies, weak internal control environments, and lack of management attention to detail. , It has been a challenge for the Nigerian Banks to effectively set their growth strategies with the recent economic market. A rising interest rate environment may seem to help financial institutions, but the effect of the changes on consumers and businesses is not predictable and the challenge remains for banks to grow and effectively manage the spread to generate a return to their shareholders. Also the management of the Nigerian banks' asset portfolios also remains a challenge in today's economic environment. Loans are a bank's primary asset category and when loan quality becomes suspect, the foundation of a bank is shaken to the core.

RECENT DEVELOPMENT IN THE NIGERIA BANKING INDUSTRY

The president is totally committed to sanitise the Nigerian Banking industry, protect all depositors and ensure that no Bank is allowed to fail. In his effort of strengthening the financial system and engender financial stability, the central Bank of Nigeria has effected some changes in the executive management of the under- listed Banks : Afribank, Intercontinental Bank, Union Bank, Oceanic Bank Fin bank, Bank PHB, Spring Bank and Equatorial Trust Bank. Chukwuma (2010) commented that the recent firing of the CEOs of the above Banks by the CBN Governor must have been a surprised to many Nigerians, but to some in the financial sector, it was a day of reckoning that has been long awaited

Incentives for risky lending and wider use of capital arbitrage contributed to the deteriorating quality of bank loan portfolios in recent years Julius (2008). The central Bank of Nigeria injected fresh capital into the Banks up to the tune of N400b to ensure that the Banking system is safe but also to protect all depositors and creditors.

The central Bank of Nigeria on Wednesday, 19 August 2009, made the list of debtors known to the public. On the list are the names of prominent businessmen, Bankers and politicians. It was discovered that these people own the first five banks discovered to be shaking after auditing by the CBN to the tune of N747b. For the purpose of this paper, the debtors of the first five Banks that the CEOs were sacked would be showed below.
The largest debtors in the list are as follows:

OCEANIC BANK	INTERCONENTAL BANK	FINBANK	AFRIBANK	UNION BANK
-Notore Chemical Industries Ltd 32,392,951,000	-Ascot Offshore Nigeria Ltd 44,670,080,228.83	Aquitane Oil and Gas Ltd 3,656,502,137.27	Kolvey Company Ltd 16,500,000,000.00	-Transnational Corp. Plc. 30,863,304,173
Rahamaniyya Global resources Lt 28,589,958,000	- Rockson Eng. Limited 36,989,685,692.84	- Falcon Securities Ltd 3,049,001,918.10	- Rehoboth Assets Ltd 15,000,000,000.00	-Mts first wireless ltd 9,849,331,689
- Falcon Securties Nig. Ltd. 22,260,476,000	United Alliance Company of Nig. Ltd 16,247,686,168.18	- Spring board Trust and Invest Co. Ltd 1,944,938,367.83	- Resolution Trust and Invest Co. Ltd 12,000,000,000.00	- Zenon 6,251,658,228
- Mid-Western Oil & Gas Coy Plc 23,863,485,000	-Accountant General Special Project 14,528,671,304.81	- Jevkon Oil and Gas Ltd 1,608,912,798.75	- Petosan Property and Dev. Co.Ltd 10,000,000,000.00	- IRS Airlines Ltd 3,331,882,287
- Spark West Steel Industry 18,449,629,000	-Rahamaniyya Oil and Gas Ltd. 12,799,823,561.55	- Ruhanti Nig.Ent. 1,073,172,545.37	-Larix Nig. Ltd 6,100,000,000.00	-Bao Yao Huan Jian 3,136,303,163
- Global Fleet Industry Ltd 14,782,994,000	-Dansa Oil and Gas Limited 8,836,682,542.69	DE – LORDS Securities Ltd 942,506,602.57	- African Petroleum 12,804,121,542.49	- Ziklagsis Networks 4,339,343,543
		- Frajend Investment Nig. Limited 941,360,020.26	- Suletical Nig. Ltd. 5,000,000,000.00	- Ibeto Industries 2,479,103,704
			-Brunel Engr. 6,935,006,115.89	-Communication Trends Ltd. 1,127,361,164

These are the largest debtors and the debts are as at may 2009. Thirty – five customers are indebted to Intercontinental Bank Plc, 28 to Afribank, 22, Union Bank Plc, 32, Oceanic Bank and 104, Finbank Plc.

The loans are non performing and that led to the sack of the Bank MDs because they failed to applied the risk management rules especially their exposures to margin loans and the oil and Gas. Sanusi (2010) also made it known that there is a general failure in recognising the limitations of the banking system when it comes to delivery economic development. The recent reform by the current CBN Governor is to put the Nigeria bank to shape. Chris (2011) in his report suggested that there is need for the establishment of a strong institutional investor's base that will spur the banks for behavioural change.

RISK FACTORS IN THE BANKING INDUSTRY:
The following are the risk factors in the Banking industry:
- Credit risk

- Liquidity risk
- Interest rate risk
- Market risk
- Operational risk
- Legal risk
- Reputational risk

CREDIT Risk

Joel (2009) in his book, defined "Credit Risk" as the risk of losses in on – and off – balance sheet positions arising from movements in market prices. The risks subject to this requirement are:

1. The risks pertaining to interest rate – related instruments and equities in the trading book.
2. Foreign exchange risk and commodities risk throughout the bank.

Credit risk is also the risk of loss due to a debtor's non-payment of a loan or other of credit (either the principal or interest (coupon) or both This definition is expanded to include the risk of loss in portfolio value as result of migration from a higher grade to a lower one. The risk arising from the type and nature of credit activities undertaken by the bank include the following:

- appetite of the bank,
- the nature of counter party exposures involve in the bank's products and services,
- Portfolio characteristics and the nature and extent of credit risk mitigation.

For most banks, loans are the largest and most obvious source of credit risk, losses in bank portfolio stem from outright default due to inability or unwillingness of a customer or counter party to meet commitment in relation to lending, trading, settlement and other financial transactions.

STEPS BANKS SHOULD TAKE TO MANAGE CREDIT RISK INCLUDE:

1. Establishing an appropriate credit risk environment
2. Operating under a sound credit – granting process
3. maintain an appropriate credit administration, measurement and monitoring process
4. Ensuring adequate controls over risk.

Although specific credit management practices may differ among banks depending upon the nature and complexity of their activities, a comprehensive credit risk management programme will address these four areas. These practices should be applied in conjunction with sound practices related to the assessment of asset quality, the adequacy of provisions and reserves, and disclosures of credit risk.

LIQUIDITY RISK

Liquidity Risk is the ability of a bank to fund increases in assets and meet obligation as they come due, without incurring unacceptable losses. The fundamental role of banks in the maturity transformation of short-term deposit into long-term loans makes banks inherently vulnerable to liquidity risk. Effective liquidity risk management helps ensure cash flow obligations, which are uncertain as they affected by external events and other agents behavior.

SOME PRINCIPLES THAT BANK USE IN MANAGING LIQUIDITY RISK

A bank is responsible for the sound management of liquidity risk. A bank should establish a robust liquidity risk management framework that ensures it maintains sufficient liquidity, including a cushion of unencumbered, high quality liquid assets to withstand a range of stress events, including those involving the loss or impairment of both unsecured and secured funding sources.

A bank should clearly articulate a liquidity risk tolerance that is appropriate for its business strategy and its role in the financial system.

Senior management should develop a strategy, policies and practices to manage liquidity risk in accordance with the risk tolerance and to ensure that the bank maintains sufficient liquidity. Senior management should continuously review information on the bank's liquidity development and report to the board of directors on a regular basis. A bank's board of directors should review and approve the strategy, policies and practices related to the management of liquidity at least annually and ensure that senior management manage risk effectively.

A bank should incorporate liquidity cost, benefits and risks in the product pricing, performance measurement and new product approval process for all significant business activities (both on – and off-balance sheet), thereby aligning the risk-taking incentives of individual business lines with the liquidity risk exposures their activities create for the bank as a whole.

A bank should have a sound process for identifying, measuring, monitoring and controlling liquidity risk. This process should include a robust framework for comprehensively projecting cash flow arising from assets, liabilities and off-balance sheet items over an appropriate set of time horizons

A bank should actively manage liquidity risk exposures and funding needs within and across legal entities, business lines and currencies, taking into account legal, regulatory and operational limitations to transferability of liquidity.

A bank should actively manage its intraday liquidity positions and risks to meet payment and settlement obligation s on a timely basis under both normal and stressed conditions and thus contribute to the smooth functioning of payment and settlement systems.

A bank should maintain a cushion of unencumbered, high quality liquid asses to be held as insurance against a range of liquidity stress scenarios, including the loss or impairment of unsecured and typically available secured funding sources. These should be no legal, regulatory or operational impediment to using these assets to obtain funding.

A bank should publicly disclose information on a regular basis that enables market participants to make an information judgment about the soundness of its liquidity risk management framework and liquidity position.

INTEREST RATE RISK

Interest rate risk- is the risk (variability in value) borne by an interest –bearing asset, such as a loan or a bond, due to variability of interest rates. In general, as rates rise, the price of a fixed rate bond will fall, and vice versa.

INTEREST RATE RISK FACED BY BANKS:

There are five types of interest rate risk faced by Banks. They are as follows:

Basis risk:
The risk presented when yield on asset and costs on liability are based on different bases. In some circumstances different bases will move at different rates or in different directions, which can cause erratic changes in revenues and expenses.

Yield curve risk:
The risk presented by different between short-term and long-term interest rates. Short-term rates are normally lower than long-term rates, and bank earn profits by borrowing shot- term money (at lower rates) and investing in long-term assets (at higher rates). But relationship between short-term and long- term rates can shift quickly and dramatically, which can cause erratic changes in revenues and expenses.

Reprising risk:
The risk presented by assets and liabilities that reprise at different times and rates. For instance, a loan with variable rates will generate more income when rates rise and less interest income when rates fall. If the loan is funded with fixed rated deposits, the bank's interest margin will fluctuate.

Option risk:
It is presented by optionally that is embedded in some assets and liabilities. For instance, mortgage loans present significant option risk due to prepayment speeds that change dramatically when interest rates rise and fall.

Hedging interest rate **risk**:
Interest rate risk can be hedging using fixing income instruments or interest rate swaps. Interest rate risk can be reduced by buying bonds with shorter duration, or by entering into a fixed-for floating interest rate swap.

MARKET RISK.
As with other forms of risks, market risk may be measured in a number of ways. Traditionally, this is done using a value market risk and this may be measured in a number of ways. Traditionally, this is done using a value at Risk methodology. Value at is established as a risk management technique, but contains a number of limiting assumptions that constrains its accuracy. The first assumption is that the composition of the portfolio measured remains unchanged over the single period of the model. For short time horizons, this limiting assumption is often regarded as acceptable.

APPROACHES TO REGULATING MARKET RISK IN BANKS
There are three approaches to regulating market risk in banks on the basis of efficiency, competitive neutrality, and effectiveness in regulation. Each approach is judged on how well it fulfills the aims of regulation without overburdening the financial system with the cost of regulation. The three approaches are the **building bloc approach** where separate capital requirements are determined; **the internal models approach** where loss to the bank's portfolio is calculated with a specified probability over a specified holding period of time; and the **pre-commitment approach** where each bank pre-commits a capital amount to cover what is believed to be its maximum trading loss exposure over a given regulatory period. .

OPERATIONAL RISK:
Operational risk is the potential financial loss as a result of breakdown in day to day operational processes. Operational risk can arise from failure to comply with policies, laws and regulations, from

fraud or forgery. The risk arising from this type and nature of operational risk involve in the bank activities. These include direct and indirect laws resulting from inadequate of fail internal processes, people and systems or from external event (note operational risk in relation to the control environment is accesses within the relevant control sections).

METHODS OF OPERATIONAL RISK MANAGEMENT

There are 3 broad method of capital calculation for operational risk

1. Basic indicator approach - this is base on annual revenue of the financial institutions
2. standardized approach – this is base on annual revenue of each of the broad business lines of the financial institutions
3. Advanced measurement approach – this is base on the internally developed risk measurement framework of the bank adversely to the standards prescribed.

The operational risk management framework should include identification, measurement, and monitoring, reporting, control and mitigation frameworks for operational risk.

LEGAL RISK:

Legal risk arises from the potential that enforceable contact, lawsuits, or adverse judgments can disrupts or otherwise negatively affect the operations or condition of a banking organization.

REPUTATIONAL RISK

Reputational risk is any risk to an Bank's reputation that is likely to destroy shareholder value. Reputational risk leads to negative publicity, loss of revenue, litigation, loss of clients and partners, exit of key employees, share price decline, difficulty in recruiting talent. A comprehensive reputational risk assessment is necessary as an important part of a risk assessment.

SOFTWARES USED IN MANAGING RISK IN THE BANKS

The ongoing development of contemporary risk management methods and the increased use of innovative financial products such as securitization and credit derivatives have brought about substantial changes in the business environment faced by credit institutions today. Especially in the field of lending, these changes and innovations are now forcing banks to adapt their in house software systems and the relevant business process to meet these new requirements. The following are the softwares used in the Banking:

1. **SAS SOFTWARES:**

With the global economy ailing, banks needs to actively manage risk, accurately track regulatory compliance and precisely measure forecast economic capital to support business strategies. To avoid potential disaster but also uncover opportunities for growth, effective governance, risk compliance (G R C) program is necessary. SAS, the leader business analytics, assists with this business needs. SAS helps banks proactively manage enterprise-wide risk, while complying with regulations and tracking and enhancing overall corporate performance. SAS offers existing and new software solution to tackle the three parts of GRC. All build on a flexible and integrated business analytics framework

In October 2008, SAS ranked first in operational risk and GRC categories in Chartis Research's Risk Tech 100 report. "SAS brings together best-in-class qualitative and quantitative risk assessment and reporting. SAS provides a firm-wide platform to automate the collection, analysis and monitoring of risk- related information.

2. NUCLEUS SOFTWARE:

Nucleus software is a leading software power house providing innovative and pioneering software solutions for Banks Financial organizations globally. Nucleus software offers a host of competitive IT solutions and consultancy services designed to support the whole spectrum of business offerings spanning Retail and Corporate Banking, Cash Management, Credit Card Relationship Banking, Financial CRM, Credit Risk & Appraisal, Internet Banking, Data warehousing and Analytics. Nucleus Risk Management for Banking helps organizations achieve comprehensive risk governance by incorporating a performance management approach into all areas risk. Adekun, Owojori, Ishola and Felix (2011) in their study, stated that the moral view of risk taking in business assumes that shareholders make the lending and investment decisions and therefore take a risk to maximize the value of insurance if they so desire. In this case this solution addresses key requirement for financial institutions, including a quality integrated risk data infrastructure with timely access, the ability to measure exposure and risk across all risk type and books of business; and the ability to distribute incentives for consistence optimization of risk adjusted returns throughout the organization. Nucleuses has expedited and enhance customer service by automating the credit to origination, effectively tracking applications, timely disbursement, faster collections, Untimely income accruals and swift decision making.

CONCLUSION;

Despite the important role played by credits in economic growth and development of a country, it is associated with catalog of risk Aremu, Suberu and Oke (2010) . If risks are improperly assessed and prioritized, time can be wasted in dealing with it. And also spending too much time assessing and managing unlikely risks can divert resources that could be used more profitably. It is important to know that prioritizing too highly the risk management processes could keep Banks from ever completing a project or even getting started. In this case, Banks should be careful in their risk assessment in order to avoid wasting time and resources only on risk management.

Finally, Since the current CBN Governor has started by positioning the Nigerian Banks into entering the global financial market it is important that certain domestic issues be handled. Dozie, (2010) in his study suggested that it is important that such entry be combined with a commitment to open markets, adequate infrastructure, including good information, a proper framework for selected lending and sufficient transparency.

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