

Managing Risk Factors through Corporate Governance for Financial Institutions of Pakistan

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ABSTRACT

Managing risk factors in financial organizations has gained more importance in recent years because of financial crisis after recession. The purpose of study is to identify the challenges and their proposed solutions to handle the crisis under umbrella of good governance practices. The specific objective of this study is to find out the factors and challenges that effect the business of financial institutions via practicing the good governance. In accordance to this critical situation has been evaluated with the help of risk regulatory model that covers the identifying, measuring evaluating and monitoring techniques for financial institutions in Pakistan. This study also emphasis on strategies and ways to eliminate organizational internal and external risk factors through policies and modifying business models in order to get the sustainable business position and organization growth. The research findings based upon the systematic review of literature and qualitative survey from the industrial experts. This study reveals that the risk factors directly associated with the sustainable business growth when organization pays worthy attention towards the corporate governance. It also empowered the organization to build a wealthy relationship with the customers and helps to retain the small investment of customer with diversified banking products.

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1. INTRODUCTION

1.1 Background

Economic challenge has been affecting the organizational business and gave a tough time to continue their businesses in a systematic manner. It is essential for organizations to find out the solutions of problems for sustainable business development and valuable for the key stakeholders. Financial institutions focused towards generating revenue and raised stakeholder value by employing activities yet stakeholders are inclined towards appreciating and rewarding some level of stability in their anticipated returns. Financial institutions having less ability to identify, manage and control the fundamental risk factors that directly affect the business. It might be leads towards loss of stakeholder value (Folami and Jacobs 2003). Thereby, financial experts are key responsible personnel to practice the governance tools for financial business transit in order to empower the organization and provide safeguards from internal and external risk. Financial experts from top notch companies have given the systems to identify the risk but need to polish it more as per the market dynamics (Alkaraan and Northcott 2006). Another approach is to assign the task to individuals those putting their eyes on risk assessment to get insight and relate it with organizational financial strength. In order to deal with critical situation, enterprise risk management (ERM) has evolved in recent years and gives a holistic picture about the risk factors.

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find out the factors and challenges that effect the business of financial institutions via practicing the good governance. In accordance to this critical situation has been evaluated with the help of risk regulatory model that covers the identifying, measuring evaluating and monitoring techniques for financial institutions in Pakistan. This study also emphasis on strategies and ways to eliminate organizational internal and external risk factors through policies and modifying business models in order to get the sustainable business position and organization growth(Christensen et al. 2002). As a matter of fact, long term success of any organization, including a professional accounting practice, can be attained by earning a suitable risk-adjusted rate of return. Risk and return, by implication, are inversely linked to the degree that greater risk opportunities give rise to a lower “risk adjusted rate of return”, whereas lower risk opportunities produce the opposite effect. Financial institutions are reacting towards the dynamic environment surrounding in the market via revising the policies and procedures (Chelst and Bodily 2000). Hence, it is well embraced that long-term profit of financial institutions linked with the risk regulatory model rather only financial audit.

1.2 Factors associated with Risk Management

In general, risk has been defined in terms of the possibility of threat, loss, injury, or other untoward consequences. Whilst in accounting and finance risk is seeing in terms of decision trees, cost-volume-profit analysis, models for capital assets pricing, probability distributions, and discounted cash flow(Duttaand Reichelstein2002).Risk management is stated as the process by which organizations address the challenges that faced by the organization in business process to achieve their goals and targets. Enterprise risk management is directly aligned with the business strategy and built a culture to practice risk management in routine business operations.Financial institutions offered services to their clients namely audit, tax and business consultation(Lawrence and Ba2002). Business risk is linked with the loss of future income, threat to reputation, and exposure to legal liabilities.In order to minimize the challenges and risk factors there is need to consider the systematic approach for managing accounting risk for financial institutions(Dickinson 1974). Self-protection of financial assets can be optimizing through efficient practices of legislation and regulation. Along with that there is need to ensure the best practices of audit, verification and testing of business operation and identify the gaps where the information spread out in the market about organizational business(Grody et al. 2011).

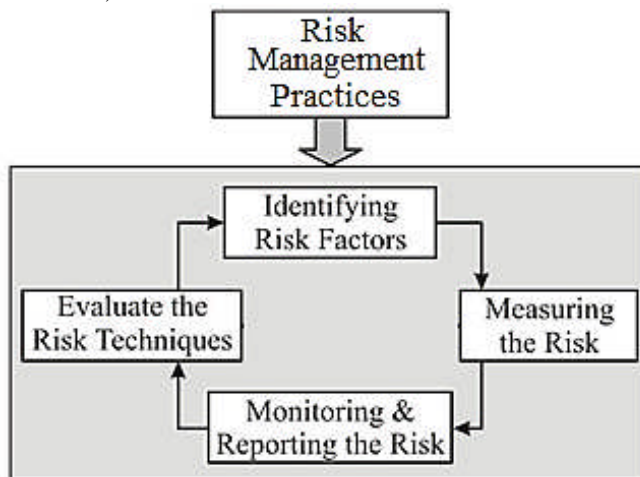


Figure 01.Risk Management Regulatory Model

2. REVIEW OF LITERATURE

Although the accounting and finance emphasis on accountability of business while several risk are not detectable and measurable. Risk of litigation, loss of chief employees, economic downturns, natural disasters and loss of reputation is subjective decisions but can't quantify it more (Pettigrew 2002). Therefore, risk is socially constructed to a certain extent and reactions to risk are a direct reflection of that social construction. There is a marked variation between objective (measurable) risk and subjective (perceived) risk. Collier et al. (2006) explained that risk can be seen as a reference to the existence of external or internal events, details concerning those events (i.e. their visibility), managerial sensing about events and information, like how they are perceived, and how firms establish informal (tacit) and formal (explicit) methods of handling risk.

Everyone has a tendency to accept risk but the tendency to take risk differs from individual to individual, being affected by the potential gains of risk taking and perceptions of risk that are driven by experience of "accidents". Therefore, individual risk taking reflects a balance between perceptions of risk and the tendency to take risks. Earlier research studies indicate that managers take risks depending on risk preferences at individual as well as organizational levels (Hooenboom and Dale 2005). Few of these risk preferences differ with national culture whereas others are individual attributes. Risk perceptions being a cultural process, every culture is associated with set of shared values, whereby supporting social institutions are biased toward focusing on certain risks and ignoring others (Hopper et al 2007).

2.1 Risk Treatment in Accounts Management

Collier et al. (2006) suggested that the accounting literature tackles risk as it comprises of probabilities within decision trees; employs probability distributions within discounted cash flow analysis; and also tries to integrate constituents of uncertainty in CVP analysis. Furthermore, definition of risk in accounting is very narrow and contains some restrictions. A few of these include reduced human involvement and human agency for the treatment of risk, risk has been seen as negative, although the well accepted concept of a risk-return trade off. Lambert (2001) elaborated that risk is an event which occurs and severely affect the objectives of organization over the period of time. Shaoul (2005) advocated that risk must be coaxed in British government's (PFI) Private Finance Initiative. Furthermore, Torok and Wood (2006:38) also suggested that "Risk itself cannot be managed", however, it is possible to "influence both the likelihood and consequence of adverse events" via involved in assessing, evaluating and treating risk.

2.2 Managing Risk through Decision Trees

Managing financial risk through decision trees is an effective tool to overcome the challenges and assess the market dynamics in an effective manner. Chelst and Bodily (2000) point out that decision trees are used to incorporate risk and produce the best alternative for a decision. Hooenboom and Dale (2005:153) justify that the decision trees are graphical representations of a series of decisions given the result of uncertain future events as well as uncertain payoffs and costs. Additionally, an explicit finding indicates that the decision makers usually gather the data that based upon the expert opinion to comprehend the nature of risk but failed to deal with the possibilities. It comes under the responsibility of risk evaluator to do the in depth work on risk assessment and calculate the probability that affect the organizational business. Alkaraan and Northcott (2006) highlight that the managers made decision on the basis

of general findings and missed the business opportunities since the decision making frameworks intended to reduce the risk. Sometime decision tree gives appropriate finding to save the organization from losses but it also missed the opportunity to gain business.

2.3 Cost-Volume-Profit (CVP) Analysis

CVP is a potential tool typically used for short-term planning analysis and can be used in several situations such as “during break-even analysis, calculating price strategy, finding out special order/ booking acceptance or choice of sales mix” (Phillips 1994:31). Traditionally, CVP model does not perform risk analysis during a decision-making process. The model presumes that variable costs will differ according to sales volume, being the only element shaping revenue, costs and profit. But organizations are operating in an environment having considerable turbulence. In short, there are various factors other than sales volume which affect revenue, costs and profit. Thus, Dickinson (1974), have proposed that CVP analysis must accept risks within its underlying model. It is feasible for managers to obtain the information that anticipated profit probabilities are estimated by a variety of sets of prices. Decision makers accessed the market information related to the stock prices and other variables that affect profit to aid decisions. Phillips (1994) conducted a case study titled “Welsh Hotel: Cost-volume-profit analysis and uncertainty”. In this particular case study, the CVP analysis was aimed at helping managers generate the budget for the years to come.

2.4 Discounted Cash Flow (DCF) Analysis

DCF techniques have been broadly employed by firms to study capital expenditure and investment decisions. The net present value and internal rate of return are two extensively used techniques of discounted cash flow analysis (Yao and Jaafari 2003). DCF methods can be used under conditions of certainty along with the risk. The rate of return is based on a company’s weighted average cost of capital, which is the discount rate used in DCF. Weighted cost of capital must be adjusted and update by market risk (Christensen et al. 2002; Dutta et al. 2002; Lambert 2001). Management accountants adjust the weighted cost of capital so as to include the sum of risk free rate and risk premium. The magnitude of market risks (also known as non-diversifiable risks) being beyond management’s control which is directly proportional to the discount rate which is used to discount the project’s overall cash flow. Hence, it is most feasible to take account of risks by means of an analysis involving worst-case, best-case scenarios.

3. RESEARCH METHODOLOGY

This research study elaborates the conceptual and analogical framework by conducting systematic review of risk factors involved in accounting and financial matters of financial institutions. Snow ball sampling technique was used to formulate the concept through expert’s interview from different financial institution in Pakistan. Qualitative data gathered from financial and risk experts during survey from the different job positions of financial institutions. Researchers also observed and analyzed the work activities of risk experts of the reputed financial institutions after getting consent.

4. ANALYSIS, FINDINGS AND DISCUSSION

This study has drawn findings on the bases of systematic review of available literature and from experts’ opinions through interviews which are mention below:

4.1 Narrative Research Analysis

Below mentioned narrative research findings refers towards the risk management and corporate governance practices for financial institutions.

4.1.1 Risk Management Practices

The research findings drawn from the systematic review of literature indicate that the current business market is largely depends upon the economic indicators. On the other hand, business owners pay worthy attention towards the governance indicators at economic level that gives safety and financial security. Furthermore, it also focused on the risk regulatory model that covers the identification of risk, how to evaluate, monitor and control the external risk factors. The risk management practices are effective for performance improvement for the financial institutions by minimizing internal risk via practicing regulation of regulatory bodies (Collier 2006). The fundamental knowledge of risk factors provides extensive support to tackle the worst case scenario in financial institutions. Effective risk management practices drag out the return on investment and increase the number of stakeholders. It is noticed that the business investors faced the uncertainty in the market and unable to make the decision for investment looking for the financial counseling from the risk experts. Although several research studies conducted on risk management practices which point out that the risk is usually based upon the external factors and difficult to manage by experts because of uncertain situation of the economy. Further, investment decision made by financial institutions gave tough time to financial experts when biased information creates the complexities in decision tree. Risk management process is relied upon the conceptual and logical understanding of risk factors for effective decision making. Risks that can be eliminated, risks that can be transferred to others, and risk that can be managed by institution is classified by the collected data for risk management process (Simunic and Stein 1990). The management accounting risks in financial institutions can be transferred when information available. There are several approaches supported by different scholars for risk management which comprise of risk measurement and mitigation methods for internal and external risk. The risk factors are not only the responsibility of internal audit and audit committees. The internal management of the organization should play a part to monitor and evaluate the organizational management accounting risk issues. Further, internal management can initiate the process to record the financial risk through review reports on monthly basis. In this regard, supervisory board can be maintained, who will analyze the risk factors, monitors and report the results for key stakeholders. This will create the strong relationship with the organizational stakeholders. If the upper level management and corporate executives are well versed in risk management procedure and operational risks which arises from human errors can be reduced vibrantly. There must be harmony in regulations of risk management of banks situated in different countries for the long term perception and risk management approach. The upper level management and risk management team are responsible to form risk free policies and procedures for the entire banking operations. Risk management process which often associated with risk evaluation techniques, policies and procedures, measurement, risk identification, monitoring and controlling, but all these steps cannot be effectively exercised unless the issues well-performed by corporate governance and internal control assignments. It is necessary to build insight when making decision for investment. The governance tools and techniques should be implemented at each stage of organizational financial decision. In resultant, risk bearing capacity of financial institutions minimize over the period of time because of poor practices of risk management regulatory model. Due to lack of knowledge and wisdom risk mitigation policy and procedures is not well designed at the end of financial institutions so far

it leads towards the merger and acquisition. The narrative research finding reveals that managing risk factors through good governance practices for financial institutions of Pakistan is associated with the policies, procedures and follow the rules that assigned by regulatory bodies.

4.1.2 Corporate Governance Practices

The corporate governance is liable for well-structured and clearly defined objectives and means for achieving the financial objective. The corporate governance has a positive or negative consequence on financial institutions in managing risk and availed the new business opportunities in the market. Good governance practices at end of institutions and regulatory bodies increases the trust and faith of stakeholders. Most of the time, institutions attract the investors with greeting but shared the less information about the market, ineffective fund utilization techniques and less likely interested to share the liquidity threats. The operational risks are also effectively managed with the help of corporate governance. Operational risks arise due to the human errors and faults. This can be effectively reduced if the board of directors and corporate authorities are well versed in financial transactions. There should be team of risk experts along with the governance analyst to monitor the risk that faced by financial institutions. Good governance practices come under the control of directors, executive managers, and internal auditors those considered as key personnel for practicing risk management regulatory model. It has been extracted from systematic review that financial risk management is based upon the internal control and continuous check and balance of financial activities which is driven from corporate governance.

4.2 Qualitative Research Analysis

Below mentioned qualitative research findings refers towards opinion poll of financial advisors and risk management experts of financial institutions of Pakistan through open end questions during interviews. Due to permission issue researcher can't add the name of interviewee and their institution name.

Q.1. Does organization has appropriate risk management system?

This is a time to practice the innovative and IT based solution for tackling the risk factors (internally or externally) in the financial market and competes with new product and services that offered to the existing and new client. To some extent investment banks practices the risk management system in association with their financial consultants to generate the short reports for the internal management. Furthermore, diverse work approaches support the internal management system and extract the knowledge of the experts and codify it into the explicit form.

Q. 2. What are the current practices is considered for controlling the risk?

The essential part for the banks and other financial institutions is to seek the new ways for business expansion that work for the benefit of investors. Organizational business units combating business challenges via effective utilization of numeric data but it usually based upon the individual's understanding those are working in the organization. In order to deal with critical situation, corporate risk management (CRM) framework helped a lot to measure the impact of risk and estimate the losses in case of uncertainty in the market.

Q. 3. What are the challenging scenarios faced by the risk experts and how it can be tackled?

The current business operations in the market faced the critical situation after the period of recession. The circulation of money comes under a boundaries and it's not easy task for the risk experts to build confidence of the investor and acquire his/her saving. Customer relationship management is considered an innovative technique to intake more cash in the banks and slightly focused towards the bank reserves.

Q. 4. What are the possibilities in occurrence for each risk?

The possibility of risk is depends upon the saturation of business market which is directly controlled by the business leaders or small business owners. The financial crunch can be the reason for maximize the risk for banks in Pakistan. On the other hand, mutual interest of the communities provides extensive support to overcome the challenges and maintain the sustainable growth in the market. When investor pays attention towards the banking products and retain them for a longer period of time then it support financial institution to minimize the risk factors in the market.

Q. 5. Are mark-up rates directly effects on organizational performance and growth rate?

Banking and financial institutions largely based on the mark-up rates and interest rates. The services offered to the particular clients composite with the time frame and organization charge the particular (interest) amount.

Q. 6. Is there monitoring process considered for the credit limits of individual?

Monitoring cell in the organization is connected with the internet system and each transaction of the customer is updated when the transaction is processed. When the customer crossing the daily limit of the cash then auto generated monitoring cell is activated and alert to the IT department, as well as send an information message to the customer for building a positive relationship.

Q. 7. Is there web application exist in the organization for estimating the risk factor?

Financial institutions provide the internet and intranet facility to field workers and provide them a scheduled plan. This technique is highly supportive for the experts and non-expert personnel to gather the relevant information about market situation. This technique helpful for the internal management to take effective decisions and assessed the impact of upcoming risk factors in the market and estimated the profit on clientele bases.

Q. 8. Have organization conduct sensitivity analysis for measuring the risk factors?

Credit risk is one of the most important types of risk for the financial institutions. The recent crisis and bankruptcy of different banks around the world have warned the management about credit risk. There is need to design the credit risk management policy at micro level. Credit risk arises when counterparty fails to fulfill its obligations on agreed terms within limited timeframe. So far financial institutions largely invest on the web based application for measuring and analyzing different factors of credit risk on the bases of current market situation.

Q. 9. What safeguards are in place to protect the organization from risk in the market?

Mostly banks focused towards the precautionary approach for controlling and minimizing the risk factors. There is no-doubt risk management is a continuous process. It requires systematic review of experts reports along with the conceptual and logical assessment of risk indicators. In depth study of market financials provide extensive support to categorized the risks. The business risks can be transferred by dealing with financial institution and risk avoidance involves standardization of all business related activities, information of versatile portfolio.

5. CONCLUSION

The entire risk management process constitutes systematic flow of the policies and procedures which adopt inside by the financial institutions. Qualitative findings of this study indicates that the standard procedures and policies play a vital to mitigate the risk factors in financial institutions and capable them to strengthen their businesses. The services offered by financial institutions such as banks also encourage the ethical business practices rather than immoralities and corruptness. It is justified that the financial risk and crisis can be tackled by effective implementation of corporate governance in financial institutions. Risk regulatory model comprises of four pillars such as identify, measure, evaluate and monitor the business activates of stakeholders provide the bases for estimation of internal and external risk. This study reveals that the risk factors directly associated with the sustainable business growth when organization pays worthy attention towards the corporate governance. It also empowered the organization to build a wealthy relationship with the customers and helps them to retain the small investment of customer with diversified banking products.

6. RECOMMENDATION

There are few recommendations that can be helpful for the financial institutions to overcome the challenges and mitigate the risk. There is need to establish the knowledge base system for evaluating the risk on tenure basis and synchronize the internal and external source of information. Training sessions is to be conduct in financial institutions under assistance of risk experts and financial scholars which groom the knowledge skills of banking staff towards new and existing products. If the entire groom management focused towards the client management system then it should be based upon the real market situation. Risk monitoring system should be effectively implemented in internal management among the top level management of the organization. There is need to establish the culture of knowledge base team and workers who are capable to face the market challenges and share tacit and explicit knowledge to minimize the risk factors. Additionally, the new product and services offered to the investors.

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