The Impact of Corporate Governance on the Adoption of Enterprise Risk Management (ERM) Practices by Banks in Zimbabwe

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Abstract:- The purpose of this paper is to establish the relationship between corporate governance and the adoption of Enterprise Risk Management by banks in Zimbabwe.

The research was based on 26 banking institutions in Zimbabwe and primary data on enterprise risk management practices was collected through questionnaires which were distributed to chief risk officers/risk/managers of the banks. Secondary data on corporate governance variables was collected through a review and analysis of published financial statements of the banking institutions for the year ended 31 December 2011.

The study results revealed that that board independence and ownership structures are essential elements that influence the decision to adopt ERM by banks in Zimbabwe. However the research found that the size of the board has no relationship with the extent of adoption of ERM.

The research also found out that owner managed banks (i.e. with directors' ownership concentration) are unlikely to adopt ERM while those with institutional shareholders concentration are more likely to adopt decisions to implement ERM. The study recommended the regulatory authorities to ensure that there is separation of ownership and management in banks to avoid abuse of structures through overbearing influence by 'owner managers'

This research therefore concluded that corporate governance has important implications on the extent of adoption of ERM by banking institutions in Zimbabwe.

Keywords:- *Corporate governance, ownership concentration, enterprise risk management, financial stability.*

I. INTRODUCTION

The international financial system was greatly affected during the global crisis that took place between 2007 and 2009. In Zimbabwe the financial crisis began as early as 2004. A number of financial institutions collapsed in many countries. One of the reasons cited for failure of these financial institutions d weaknesses in corporate governance arrangements including poor risk management systems.

In Zimbabwe, a number of banks namely ENG Capital, Royal Bank, Barbican Bank, Time Bank, Sagit Finance House, Renaissance Merchant bank, Interfin bank to mention but a few collapsed during the period 2003 to 2012. The failure and collapse of the above institutions revealed on one hand serious lapses in corporate governance practices and on the other hand failure in risk management systems. Thus the importance of effective corporate governance arrangements cannot be over-emphasized.

The Reserve Bank of Zimbabwe (2004) noted that most of the problems that affected the financial system in Zimbabwe were of a corporate governance nature as lack of judicious and prudent risk management exposed some banks to unscrupulous individuals who were engaging in irregular and unorthodox practices detrimental to financial stability.

The risk management failures highlighted above forced banking institutions to scrutinize their risk management systems and approaches. Most banks are placing a great emphasis on enterprise-wide risk management (ERM). According to Young (2003) the implementation of robust risk management practices such as enterprise risk management is an important corporate governance requirement that will assist in effective decision-making and monitoring. Risk management is considered as one of the key aspects of corporate governance [Vassileios (2011), Adamson (2011)].

It can therefore be postulated that corporate governance and enterprise risk management issues are critical considerations in ensuring the safety and soundness of banking institutions. It is therefore important to understand the relationship between these two principles i.e. corporate governance and enterprise risk management.

This paper therefore seeks to examine the relationships between the various corporate governance mechanisms and the extent of implementation of Enterprise Risk Management in the Zimbabwean banking sector.

II. LITERATURE REVIEW

A. Background

There is no standard definition of corporate governance. In simple terms it refers to the way in which the affairs of a company is governed to achieve the set corporate objectives [Greuning and Bratanovic (2003)]. The Reserve Bank of Zimbabwe (2004) refers to corporate governance as the processes and structures used to direct and manage the business and affairs of a company.

On the other hand Enterprise Risk Management (ERM) is a holistic, integrated approach to managing a company's risks, in contrast to the so-called "silo-approach" prevalent in many firms in which risks are managed independent of each other (Alviniussen and Jankensgård 2009). Another notable definition of ERM is by the Casualty Actuarial Society (2000) who define ERM as: "the discipline by which an organization in any industry assesses, controls, exploits, finances, and monitors risks from all sources for the purpose of increasing the organization's short- and long-term value to its stakeholders."

According to **Vassileios (2011)** there is an increasing recognition that corporate governance has a relationship with enterprise risk management. Chapman (2006) posited that corporate governance is a critical component of effective enterprise risk management because it provides the board and senior management with the tools and techniques for 'the top down' monitoring and management of risk management.

Corporate Governance and risk management are considered to be one side of the same coin. On the other hand, the two concepts can be regarded to be complimentary in assisting the board to run and govern the affairs of a bank in a safe and sound manner. The linkage between corporate governance and risk management can be explained by looking at the element of achievement of objectives.

Corporate governance is the way in which a firm is controlled and governed to **achieve business objectives**. Risk management establishes a process of identifying, analyzing, monitoring and controlling risks which could prevent the firm from effectively achieving its objectives. Risk management therefore provides the control systems which gives reasonable assurance to the board and senior management that the business objectives will be achieved within acceptable risk tolerances.

Dahms (2008) sums up the linkages between the two (i.e. corporate governance and ERM) by highlighting that that corporate governance is the glue that holds a company together in pursuit of its objectives, and risk management provides the resilience. He concluded that effective risk management is the cornerstone of sound corporate governance.

B. Corporate Governance Measures

A number of variables used as proxies for corporate governance by researchers relate to characteristics of the board of directors thus indicating the importance of the board. The most popular variables or corporate governance measures include board independence, board size, board composition, duality of CEO/Chairman, ownership structures, separation of ownership and management.

This study will focus on three corporate governance variables namely board size, board independence and ownership structures (independent variables) and ERM implementation as the dependent variable.

C. Board Size

Levrau and Van den Berghe, (2007) define board size as the number of directors on the board of a firm or organization. The number of directors on the board is an important board characteristic which ensures efficient and effective board deliberations and monitoring.

There is no generally acceptable agreement on the best possible size of a board of directors that would guarantee board effectiveness. The Reserve Bank Corporate Governance Guideline 1-2004 requires banking institutions in Zimbabwe to have a minimum of five directors. Jensen (1983) recommends that a board size of not more than seven (7) or eight (8) members is considered reasonable in ensuring effectiveness.

A number of studies were carried out to ascertain the influence of board size as a corporate governance variable. These studies however, proffered conflicting views in support of either larger or smaller board sizes.

Studies by Goodstein *et al*., 1994; Jensen, 1993; Florackis & Ozkan 2004; Rahman and Ali, 2006; Yermack, 1996 concluded that small boards are more effective in monitoring firm activities and also provide positive impact on the decision making capability of the board. The researchers noted that small boards are more conducive to active participation by the directors and are focused in solving any issues that arise. This group of researchers argued that larger boards could result in difficulty at a consensus in decision making and can lead to "less effective coordination and communication, and are more likely to be controlled by the CEO'.

On the other hand Zahra & Pearce (1989) and Dalton *et al*., (1999) posited that larger boards are effective at monitoring due to their large pool of expertise and better environmental links which are not normally the case with smaller boards. However, Enya He and Sommer (2006) noted that board size is positively related to board independence, indicating that large boards tend to have more outside directors, consistent with Boone et al. (2004) and Linck et al. (2006).

D. Board Independence

According to Jidong and Liyan (2010*)* board independence is measured by the percentage of independent non-executive directors on the board. This is premised on the fact that independent non-executive directors bring an independence that carries with it a belief of better-quality impartiality to board decisions and in monitoring and providing oversight on the activities of executive directors. [Cadbury (1992) and Hampel (1998)]. It is thus regarded as a vital causative factor to effective monitoring.

ANAO ((1999) argue that the independence of directors is essential to mitigate any potential conflicts of interest and to ensure effective board oversight on the activities of management. This is further supported by Fama (1980) who posited that independent non-executive directors are essential for monitoring the actions of the executives and of ensuring that policies consistent with shareholders' interests are pursued.

Desender (2008) highlighted that firms with independent boards (i.e. with a larger proportion of non-executive directors are more likely to implement more broad and structured risk management systems such as ERM to compliment their own monitoring responsibilities.

However, other group of researchers such as Chen, Cussat & Gunny 2003; Linck et al. 2008; Lehn et al. 2009; Boone et al. 2007; Duchin et al. 2010 highlighted that board independence does not necessarily result in effective board oversight or monitoring. The researchers noted that independent non-executive directors rely on information provided by executives, which in a number of cases may suit the interests of executives. This may make the independent non-executive directors less effective.

E. Ownership structure and exercise of control rights

Ownership structure is refers to the types and composition of shareholders in a company. A firm whose shareholding is skewed towards a group of shareholders is said to have ownership or shareholder concentration. Htay, Ab. Rashid, Adnan and Meera (2011) highlighted that there are three forms of ownership concentration namely directors' ownership, block ownership and institutional ownership.

Previous studies have shown that ownership concentration have an influence on board decisions. In a highly concentrated firm, the majority shareholders are expected to dominate board decisions. Large shareholders, because of their large equity stake are interested in long term performance of the business and they act as good monitors (Bushee, 1998). Further, Shleifer and Vishny (1986) argue that large shareholders have a strong incentive to monitor managers because of their significant economic stakes.

This research examined whether differences in ownership structure across banking institutions can explain differences in the level of adoption of ERM among banking institutions on Zimbabwe.

F. Studies on relationships between ERM and Corporate Governance

Daud, Yazid & Hussin (2011) in their study "An Examination of Enterprise Risk Management (ERM) Practices among the Government-Linked Companies (GLCs) in Malaysia" noted that the quality of the board (corporate governance variable) had an influence in the adoption of ERM. The researchers concluded that the quality of board of directors' play a significant role in the adoption of ERM by firms. The above results were also corroborated by another sole research by Daud (2011), who, among other variables undertook a study to establish the relationship between the quality of the board and the extent of implementation of ERM among a sample of 89 firms quoted on the Bursa Malaysia. The other variables studied were the quality of the CRO and the quality of the internal audit. The researcher established that there was a positive relationship between the board and the adoption of ERM.

Waweru and Kisaka (2011) researched on a sample of 22 firms quoted on the Nairobi Stock Exchange to establish the determinants of ERM adoption. The corporate governance variable included in the study (in addition to appointment of chief risk officer, industry of operation, level of board independence, size of the firm and growth rate of the firm) was the level of board independence. Whilst the authors established that there was positive relationship between the appointment of the CRO and the extent of ERM adoption, research concluded that there is no significant relationship between the independence of the board (corporate governance) and the adoption of ERM among the Nairobi Stock Exchange listed companies.

Desender (2007) in his study "The influence of Board Composition on Enterprise Risk Management" studied, among other variables, the influence of the composition of the board on ERM. The researcher used two corporate governance variables namely board independence and duality of the Chairman and the CEO on a sample of 100 companies in the pharmaceutical industry. The researcher found out that board independence alone does not influence the decision to adoption of ERM. However it was noted that board independence in combination with separation of the chairman and CEO has a positive influence on the adoption of ERM. Based on the above findings it can be concluded that corporate governance has a positive influence on the implementation of ERM.

Beasley, Clune, and Hermanson 2005b found out that board independence which is a corporate governance variable was positively related to the extent of adoption of ERM. The research findings contradict those of Paape & Spekle (2010) and Desender (2007) who concluded that there is no significant relationship between the independence of the board and the level of implementation of ERM.

Seamer, Choi and Lee (2011) studied the effect of corporate governance mechanisms on the rigour of ERM strategy adopted by firms using a sample of 22 firms listed on the Australian bourse. The researchers used the existence, independence and skills of the audit committee as well as the duality of the CEO/Chair roles as variables for corporate governance. The researchers concluded that the existence and independence of an audit committee as well as the existence of a financial expert on that committee are the dominant drivers of or greatly influenced the decision to adopt the ERM strategy. The study therefore concluded that the rigour of an existing ERM system was most influenced by corporate governance.

III. PURPOSE OF THE STUDY

The purpose of the study was to establish the relationship between corporate governance and the adoption of Enterprise Risk Management by banks in Zimbabwe.

A. Research objectives

- To establish a relationship between board independence and decision to adopt ERM by banks in Zimbabwe.
- To establish a relationship between ownership structure and adoption of ERM by banks in Zimbabwe.

- To establish a relationship between board size and the adoption of ERM by banks in Zimbabwe.

IV. METHODOLOGY

The unit of analysis for this study was all the 26 registered banking institutions in Zimbabwe.

Primary data on risk management practices in banks was collected through questionnaires which were distributed to chief risk officers/risk managers in the 26 registered banking institutions. Purposive/Judgmental sampling was used to select respondents for this study. This sampling approach was designed to ensure that selected respondents have the sufficient knowledge and understanding of enterprise risk management issues in their respective banking institutions. A total of 23 questionnaires were received back translating to a response rate of 88.46%.

Secondary data on corporate governance variables was collected through a review and analysis of published financial statements of the 23 out of 26 banking institutions for the year ended 31 December 2011.

The corporate governance variables used for this research are board size, board independence and ownership structure. On ownership structure the study focused on directors' ownership concentration and institutional ownership concentration variables. The dependent variable for the study was the adoption of ERM.

Board size was measured by the numbers of directors sitting on the board while board independence was measured by the proportion of independent non-executive directors on the board of directors.

Ownership concentration was measured as the cumulative sum of the percentage of largest shares held by the first three directors (directors' ownership) and the percentage of shares for the largest institutional investor (institutional ownership).

The research was mainly descriptive in nature.

V. FINDINGS AND DISCUSSIONS

A. Relationship between Board Size and adoption of ERM

Table 1 below shows the distribution of sizes of boards within the Zimbabwean banking sector. The results show that the majority of boards have directors numbering between 9 and 12 while the boards of four banks comprise more than 12 directors.

Table 1: Board Size

Number of Banks	Number of banks	Percentage
Number of board members less than 8	4	17.39%
Number of board members between 9 and 12	15	65.22%
Number of board members more than 12	4	17.39%
Total		100%

Source: Annual reports of banks

Table 2: Board Size Vs Extent of ERM Implementation

Number of Board Members	Fully Implemented	Partially Implemented	Plans to Implement	Not Implemented
Less than 8	13.04%	4.35%	-	-
Between 9 and 12	4.35%	17.39%	30.44	13.04%
More than 12	4.35%	8.70%	4.35%	
	21.74%	**30.44**%	**34.79**%	**13.04**%

The results illustrated in Table 2 above show that the size of boards of the five banks which have fully implemented ERM are spread among the three categories namely (i) less than 8, (ii) between 9 and 12 and (iii) more than 12. A look at banks that have partially implemented ERM shows that their board sizes also fall within the above three categories. The above results indicate that there is no relationship between the size of the board and the adoption of ERM. This therefore means that the size of the board is not an important factor in the extent of implementation of ERM by banks in Zimbabwe.

The findings are inconsistent with those of Ruback (1983), Jensen (1993) and Florackis and Ozkan (2004) who concluded that small boards are effective as larger boards can lead to less effective coordination, communication, and decision making, and are more likely to be controlled by the CEO. They argued that the smaller boards are more likely to adopt monitoring systems such as ERM than larger boards.

B. Relationship between Board Independence and adoption of ERM

Table 3 indicates that a total of 95.65% of banks surveyed have independent non-executive directors constituting more than 40% of the board members. Only one bank has independent non-executive directors whose proportion is less than 40% of the total board members.

Table 3: Proportion of Independent Directors

Proportion	**Number of banks**	**Percentage**
Less than 40% of the total number of board members	1	4.35%
Between 41% - 50% of the total number of board members	12	52.17%
Between 51% - 60% of the total number of board members	3	13.04%
More than 60% of the total number of board members	7	30.43%
Total	**23**	**100%**

Source: Annual reports of banks

Table 4: Board Independence Vs Extent of ERM Implementation

Percentage of Non Executive Directors	**Fully Implemented**	**Partially Implemented**	**Plans to Implement**	**Not Implemented**
Less than 40% of the total number of board members	-	-	4.35%	-
Between 41% - 50% of the total number of board members	-	17.39%	21.74%	13.04%
Between 51% - 60% of the total number of board members	4.35%	4.35%	4.35%	-
More than 60% of the total number of board members	17.39%	8.70%	4.35%	-
Total	**21.74%**	**30.44%**	**34.79%**	**13.04%**

An analysis of the five banking institutions that have fully implemented ERM show that four out of the five institutions have independent non-executive directors constituting more than 60% of the board members. On the other hand the results show that 69.2% of banks with independent non-executive directors of less than 50% of the board members either have not implemented or are planning to implement ERM. This means the higher the number of independent non-executive directors on the board the higher the likelihood of adopting ERM.

The majority of the respondents highlighted that pressure from non-executive directors through the audit and risk committees has been the major driver of the extent of adoption of ERM in their banks. In terms of the Reserve Bank guidelines, audit committees are only made up of independent non-executive directors only.

The results therefore suggest that independent non-executive directors play a critical role in the adoption of ERM. The above results are consistent with the findings of Yazid, Hussin and Daud (2011).

C. Relationship between Ownership Structure and adoption of ERM

Table 5 below shows that institutional investors own at least 50% shareholding in nine out of 23 banks while the ownership structure of seven banks is skewed towards directors' ownership. The ownership structures of seven other banks are diversified.

Table 5: Proportion of Ownership Structure

Ownership Structure	**Number of banks**	**Percentage**
Top 3 institutional shareholders with at least 50% shareholding	9	13.14%
Top 3 Individuals with a combined shareholding of 50%	7	30.43%
Diversified ownership	7	30.43%
Total		100%

Source: Annual reports of banks

Table 6: Ownership Structure Vs Extent of ERM Implementation

Ownership Structure	**Fully Implemented**	**Partially Implemented**	**Plans to Implement**	**Not Implemented**
Institutional Shareholders	13.04%	13.04%	13.04%	-
Largest 3 Individual Shareholders	-	8.70%	8.70%	13.04%
Diversified ownership	8.70%	8.70%	13.04%	-
	21.74%	**30.44%**	**34.79%**	**13.04%**

The results of the study indicate that out of the five banks that have fully implemented ERM, three have institutional shareholding concentration while none of the banks which have directors' ownership concentration have adopted ERM. On the other hand, the results indicate that the bulk of banks who have either not implemented or are planning to implement ERM have directors' ownership concentration. The results mean that banks with institutional ownership structures are likely to adopt ERM than those with directors' ownership concentrations.

In respect of directors' ownership concentration the results could be attributed to the fact that most of the controlling shareholders involved in management tended to work in their own interests and benefits and would not want to put in place robust monitoring and reporting systems such as ERM that could expose their misbehaviours or check their actions.

A number of banks in Zimbabwe who have directors who own majority shares in the bank have, instead of monitoring, been at the forefront of influencing bank management to grant them or their associated companies' loans. The majority of banks that failed during the period 2003 to 2004 were a result of non-performing loans of directors and their associated companies. Further two banks that failed in 2011 and 2012 were mainly as a result of exposure to insider loans of directors and major individual shareholders which were granted as a result of overbearing influence. These findings are in agreement with those of Khoo, (2003) who noted that significant dominance and participation of major shareholders in company management allowed some of them to act in their own interests, leading to problems in their corporate firms.

VI. CONCLUSIONS

This study discusses the relationship between corporate governance and the extent of adoption of ERM in the Zimbabwean banking sector. Three corporate governance variables namely board size; board independence and ownership structure were tested to identify their respective influence on the level of ERM implementation.

The study noted that board independence and ownership structures are essential elements that influence the decision to adopt ERM by banks. However the research found that the size of the board has no relationship with the extent of adoption of ERM.

On ownership concentration it was noted that board decisions tended to be influenced or dominated by majority shareholders. The research concluded that banks with directors' ownership concentration with the directors concerned being involved in the management of the bank are unlikely to adopt ERM. This is attributed to the fact that controlling shareholders i.e. the directors in most Zimbabwean banks would be deriving benefits such as loans to themselves and their associated firms and have no motivation to introduce robust governance structures such as ERM that would provide a platform for monitoring and checking their actions. This has been the major reason for the problems encountered by owner managed banks in Zimbabwe.

There is need therefore for the Reserve Bank to ensure that there is separation of ownership and management in banks to avoid abuse of structures through overbearing influence by 'owner managers'

The research found out that those banks with institutional shareholders concentration are more likely to adopt decisions to implement ERM compared to those with directors' ownership concentration. It therefore means that ownership structure influence the level of adoption of ERM in Zimbabwean banks.

This research therefore concluded that corporate governance has important implications on the extent of adoption of ERM by banking institutions in Zimbabwe.

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