Research on Operational Risk Management in First Bank of Nigeria (FBN Bank)

Abstract

The FBN bank is the oldest and largest of the twenty-four banks operating in the Nigerian economy. The objective of this study is to assess the impact of Operational Risk Management on FBN Banks. Past literatures were reviewed and theoretical frameworks such as the extreme-value theory and risk theory of profit were adopted to support the study. The research adopted both qualitative and quantitative techniques, and the data for the study came from primary and secondary sources. Primary data questionnaires were distributed to 60 bank workers, but Only 50 surveys were returned from the served respondents, and the analysis was focused on those 50. Eventually, the respondents' responses were analyzed using simple percentages. Moreover, the secondary data were derived from the sampling deposit money institutions audited and publicly available financial statements. Following, the results were analyzed based on time series basis from 1999 to 2020 using regression estimates.

The investigation indicated that operational risk and credit risk have a greater impact on FBN banking operations than market risk. Fraud and forgeries also have a negative impact on banking operations. However, fraud and forgery risk, operational risk, credit risk, and system risk abound in FBN banking operations, all of which must be managed effectively to improve bank performance and stability. Deductively, the banks' risk management procedures have effectively minimized the different risks that FBN banks face.

The regression result revealed that operational risk management had a considerable impact on FBN banks' performance measures in Nigeria. Especially the Ratio of Non-Performing Loans to Total Loans (BRNPL), and Ratio of Cost to Income (BROCI)

has a negative significant impact on the financial stability of FBN banks in Nigeria as measured by Return on Equity (ROE).

Keywords： Commercial Bank; Operation Risk; Risk Management; Financial Stability

1.0 Introduction

It is widely assumed that a country's financial sector, through its financial intermediation functions, contributes greatly to the growth and development of its economy. Akpasung and Gidigbi (2014) argued that financial institutions play an intermediation role in the economy by assisting in the channeling of resources from the surplus idle sector to the deficit real sector, thereby facilitating productive activities, and that this intermediation role is a veritable process for investment, growth, and development. In this study we will deal with risk management in banks namely with operational risk management in banks. Again, according to Duong, Huyen, and Huong (2018), the financial system, through banking, plays a critical role in economic development, and as a result, the banking sector must be strong in order to maintain financial stability.

Financial system stability is critical not just for financial institutions, but also for any economy's growth and development, because a financial crisis could result in major cutbacks in bank loans, as well as a drop in investment and growth (Fajembola, Rahman & Md-Rus 2018). Financial stability, according to Healey, Mosser, Rosen, and Tache (2018), is the ability of the financial system to promote and enhance economic processes, manage risks, and absorb shocks. It is a state in which the economy's systems for pricing, allocating, and managing financial, credit, liquidity, counterparty, and market risks are adequate to contribute to the economy's performance (Muriungi, Waithaka, Were & Muriuki 2017). According to Dugguh and Diggi (2015), bank failures have a wide range of negative implications that affect not only depositors but also investors, the general banking public, and the entire economy.

They came to the conclusion that bank failures impede financial intermediation and efficient resource allocation, as well as individual well-being and economic advancement.

Many Nigerian banks have become financially stretched as a result of the emergence of one or more of these hazards, and have gone bankrupt as a result. For example, prior to the 2014 bank recapitalization reforms, approximately 35 banks were distressed and subsequently liquidated due to issues involving credit risk arising from inability to repay default loans, market risk arising from unfavorable exchange and interest rate movements, operational risk arising from poor risk management practices, weak corporate governance, and inexperience (NDIC 2014).

Risk management is particularly important in financial institution decision making since risk management must satisfy certain objectives to keep the organization functioning properly (Harelimana, 2017). Singh and LaBrosse (2012) agreed on the necessity of risk management in the banking sector when they stated that banks, like other businesses, will fail, and the likelihood of this happening is higher when risks in a specific banking concern are not well handled.

In addition, according to Zakaria (2017), effective risk management procedures are critical in the development of stable and sound financial institutions. The International Monetary Fund (IMF) (2019) backs up this claim by stating that the series of financial crises that occurred between the 1990s and 2008 highlighted the importance of effective systemic risk monitoring and management, which explains why the IMF has increased its efforts to assist countries in implementing policies that support sound financial systems. While credit risk, liquidity risk, and market risk appear to be the most significant risks facing financial institutions, there are other major risks that are equally important to the financial stability of banks and that, if not properly managed, could lead to bank failure. One of these risks is operational risk. Banks had traditionally focused on credit and market risk management, with only limited resources allocated to operational risk management, according to Prabhu and Shankar (2017), until operational losses began to rise significantly over time, prompting regulators and banks to take a closer look at operational risk management.

According to Kneevi (2013), the majority of bank failures are the result of internal frauds or insufficient processes and procedures that encourage employees to get involved in activities that expose banks to higher risk in order to achieve personal gain, and he gave an example of operational risk events on the LIBOR fraud case that was discovered in the summer of 2012 and resulted in a loss of about $1 billion.

1.1 Objective of the Study

The main objective of this research was to provide a comprehensive review on the statistical study of operational risk management in First Bank Nigeria

2.0 Literature Review

2.5 Some related Theories

Many academics have utilized various hypotheses to explain the impact of operational risk management on deposit money bank financial stability. In this study, the risk theory of profit, extreme value theory, and expected income theory will all be investigated. The study, on the other hand, used extreme value theory and profit risk theory. Extreme value theory was chosen because it provides a better analysis of events, activities, or financial risks that could result in significant operational risk losses, whereas risk theory of profit addresses earning capacity in relation to risk exposure in order to ensure deposit money financial stability.

2.5.1 Risk Theory of Profit

Hawley (1893) developed a hypothesis about the relationship between risk and profit, claiming that business compensates workers not just for their labor but also for their worries, and that without danger, there can be no big profit for an entrepreneur. Hawley believed that production elements should not be restricted to the three variables of land, capital, and labor, but should also incorporate risk taking, with the bigger the risk, the larger the profit. This was corroborated by Landqvist and Stalhandske (2011), who concluded that entrepreneurship would not be as fascinating as it is today if risk-taking was not involved.

2.5.2 Extreme Value Theory

According to Gumel (1958), as cited by Bukwimba (2015), Nicolas Bernoulli explained the mean largest distance from the origin when n points lie at random on a straight line of length t in 1709, when he explained the mean largest distance from the origin when n points lie at random on a straight line of length t. According to Teply (2012), one of the early research on operational risk management was conducted in 1997 by Embrechts, Klüpperberg, and Mikosch, who modelled severe occurrences for insurance and finance.

According to Garrido and Lezaud (2013), extreme value theory is a branch of statistics that deals with extreme deviations from the median of probability distributions, i.e. based on the language of probability theory and thus the occurrence of rare events that are not within the range of available data; it is one of the standard approaches to studying risks; it is a branch of statistics that deals with the extreme deviations from the median of probability distributions.

2.5.3 Anticipated Income Theory

Prochanow created the anticipated income theory in 1949 and published it in his book "Term Loan and Theories of Bank Liquidity." Regardless of the type and character of a borrower's business, the bank aims to liquidate the term loan from the borrower's anticipated income, according to this notion. This idea proposed that a bank's liquidity can be managed by properly arranging and structuring the bank's loan commitments to customers, and that liquidity can be planned if scheduled loan redemption by customers is based on the individual borrower's future (Olanrewaju and Adeyemi, 2015).

According to Fagboyo, Adeniran, and Adedeji (2018), the anticipated income hypothesis states that liquidity can be guaranteed if scheduled loan repayments are paid on the borrower's future income. The authors emphasized that the anticipated income approach, rather than relying on collateral, links loan repayment to income. While granting this loan, the bank places restrictions on the borrower's financial

activity, and when granting a loan, the bank considers not only the security but also the borrower's expected profits.

3.0 METHODOLOGY

The study's population is the first banks of Nigeria (FBN), which is currently estimated to be a Nigerian multinational banking and financial services corporation based in Lagos. It is West Africa's leading bank, having an impact that is woven into the fabric of society. However, because First Bank of Nigeria Plc is Nigeria's oldest and largest bank, it was chosen as the sample to be used. In this chapter we explained which are functions and activities of banks in general.

3.1 Data Sources

The main source of data for this research was primary, with secondary sources supporting it. The information was gathered by administering questionnaires to 60 employees of First Bank Nig PLC at their headquarters on mainland Street in Lagos. Only 50 surveys were returned from the served respondents, and the analysis was focused on those 50. Moreover, the secondary datas were derived from the sampling deposit money institutions audited and publicly available financial statements. The data's trustworthiness is confirmed by external auditors and regulators certifying the financial statements, as well as the board of directors' approval.

3.2 Research Design

The sample size of this study consisted of FBN banks selected from the total population of twenty-four deposit money banks in Nigeria as at November 30, 2020 and the data collected covered twenty-one-year period from 1999 to 2020.

Simple percentages were used to assess the data acquired from the questionnaires. The hypothesis of the study was tested using the multiple regression analysis statistical technique with a significance threshold of 5%. In order to acquire existing secondary data from the FBN bank, this research used an ex post facto research design. In order to choose samples from the study population, this study used a convenient sampling strategy, which is one of the non-probability sampling strategies.

This sampling strategy was utilized since FBN bank was purposefully chosen as sample from the general population due to the ease with which the relevant data for the study could be generated.

3.3 Model Specification

The independent variable or explanatory variable in this study is operational risk management, while the dependent variable is FBN bank financial stability. The study used the following multiple linear regression model to investigate the association between operational risk management and financial stability in FBN banks.

The study used the following models from the work of Adegbie Folajimi Festus and David Olumuyiwa Sunday to evaluate the relationship between operational risk management and financial stability of deposit money banks in Nigeria (2017).

Ratio of Non-Performing Loans to Total Loan (RNPL), Ratio of Cost to Incom e (ROCI), and Ratio of Total Loan and Advances to Total Deposit were used to assess operational risk management (RTLD). Conversely, return on equity (ROE) was used to assess financial stability (dependent variable).

FS = f (ORM)

ROE = f (RNPL, ROCI, RTLD)

ROE = $\beta 0 + \beta 1BRNPL + \beta 2BROCI, + \beta 3BRTLD + \sum$.....Equation 1

Where:

Y = Return on Equity (ROE)

X1=Bank Ratio of Non-Performing Loans to Total Loan (BRNPL),

X2= Bank Ratio of Cost to Income (BROCI),

X3= Bank Ratio of Total Loan and Advances to Total Deposit (BRTLD).

$\sum$= Error Term

3.4 Research Expectations

In order to evaluate the relationship between operational risk management and financial stability of FBN banks,

We expect that there should be a negative impact of operational risk management on the financial stability of FBN banks. This would be supported by the hypothesis that

extreme value theory is a useful tool for analyzing activities, or financial risks that could result in large operational risk losses for financial institutions, and that risk theory of profit is a useful indicator for managers in determining earning capacity in relation to risk exposure. The risk theory of profit postulated by Hawley who believed that production elements should not be restricted to the three variables of land, capital, and labor, but should also incorporate risk taking, with the bigger the risk, the larger the profit

4.0 Analysis and Interpretation of Result

Simple percentages were used to assess and analyze the data acquired from the questionnaires. However, the hypothesis of the study was tested using the multiple regression analysis statistical technique with a significance threshold of 5%.

4.1 Respondents Age Group

Table 1 below reveals the respondents age categories. It appears that there were no respondents within the age group of 19 and under. However, 30% of the respondents fall within the age category of 20-29 years, 4% of the respondents fall within the age category of 50-59 years, 10% fall within the age category of 40-49 years, 4 % falls within the age group of 60 years. Nevertheless, majority (52%) of the respondents fall within the age category of 30-39 years.

Table 1Respondents Age Group

Respondents Age Group	Frequency	Percentage
19 and under	0	0.0
20-29	15	30.0
30-39	26	52.0
40-49	5	10.0
50-59	2	4.0
60+	2	4.0
Total	50	100

Source: researchers field survey, 2021

4.1.2 Respondents Gender

Figure 1 below shows the gender of respondents in terms of male and female classification respectively. We deduce that, 45% of the respondents were male while 55% of the respondent were females. This connotes that both genders are represented true and fair without biases in the recruitment process and employee selection.

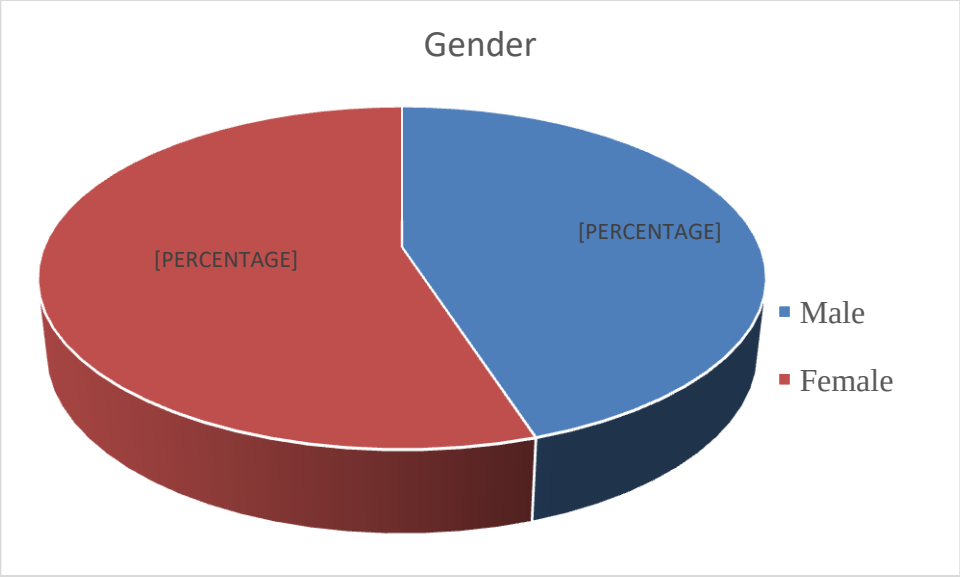

Figure 1Respondents Gender (Management and Employees)

4.1.3 Respondents Educational Background

Table 2 below represents the educational background of respondents. It shows that none were high school graduates, 6% of the respondents were two year/diploma/college leavers respectively. 40% of the respondents were bachelor degree certificate holder, 34% of the respondents were master's degree certificate holder, 8% of the respondents hold a professional degree from the institute of chartered accountants of Nigeria (ICAN) and association of accounting technicians (AAT) respectively, while 4% of the respondents were PhD degree holders.

Table 2 Respondents Educational Background

Respondents Educational Background	Frequency	Percentage
High school graduate	0	0.0
Two year/ diploma/ college	3	6.0
Four year/bachelor's degree	20	40.0
Graduate/ master's degree	17	34.0
Professional degree for example ICAN, AAT, MD, DOS etc.	8	16.0
Postgraduate degree/ PhD	2	4.0
Total	50	100

Source: researchers field survey, 2021

4.1.4 Respondent Units

From table 3 the various units to which the respondents are attached to are been demonstrated. 16% happens to work at the head office while 84% of the respondents works at the branch office.

Table 3 Respondents Units

Respondents' units	Frequency	Percent
Head Office	8	16.0
Branch Office	42	84.0
Total	50	100

Source: researchers field survey, 2021

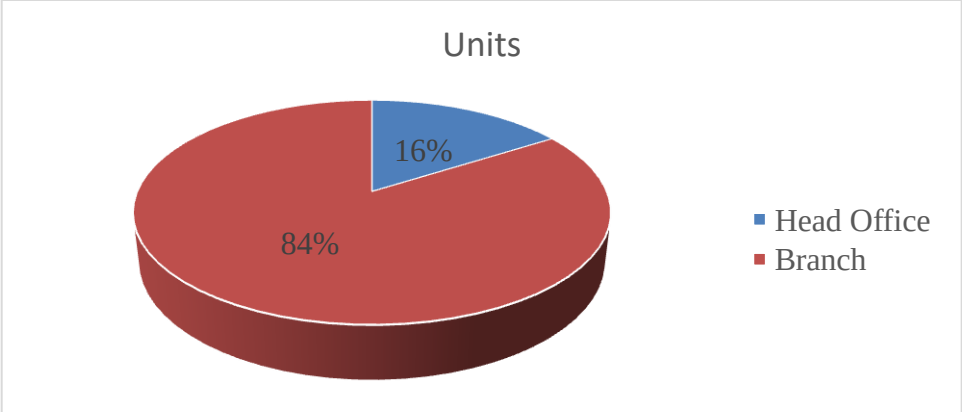

Figure 2 Respondents Gender (Management and Employees)

4.1.5 Respondents Job Position

Table 4and figure 2 represents the various job positions held by respondents. It indicates that majority (32%) of the respondents works in the operation management department, 16% of the respondents works at the credit management department, 26% of the respondent's position in retail credit management department, 6% positions are in the company business management. Conversely, 20% position are in other departments

Table 4 Respondents Job Position

Respondents Job Position	Frequency	Percent
Credit Management Department	8	16.0
Operation Management Department	16	32.0
Retail Credit Department	13	26.0
Company Business Department	3	6.0
other	10	20.0
Total	50	100

Source: researchers field survey, 2021

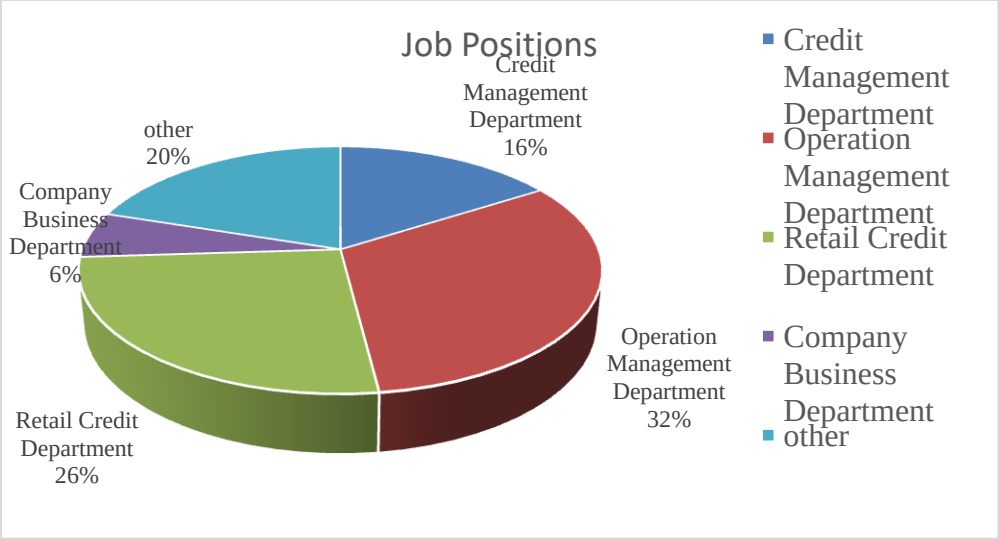

Figure 3 Respondents Job Positions (Management and Employees)

4.1.6 Respondent's Banking Experience

Figure 4.shows the respondents banking experience. It represents that 22% of the respondents have 1-2years banking experience, majority (40%) of the respondents have between 3-5 years banking experience. However, 30% have 6-10 years banking experience, and 8% have 10 or more years banking experience.

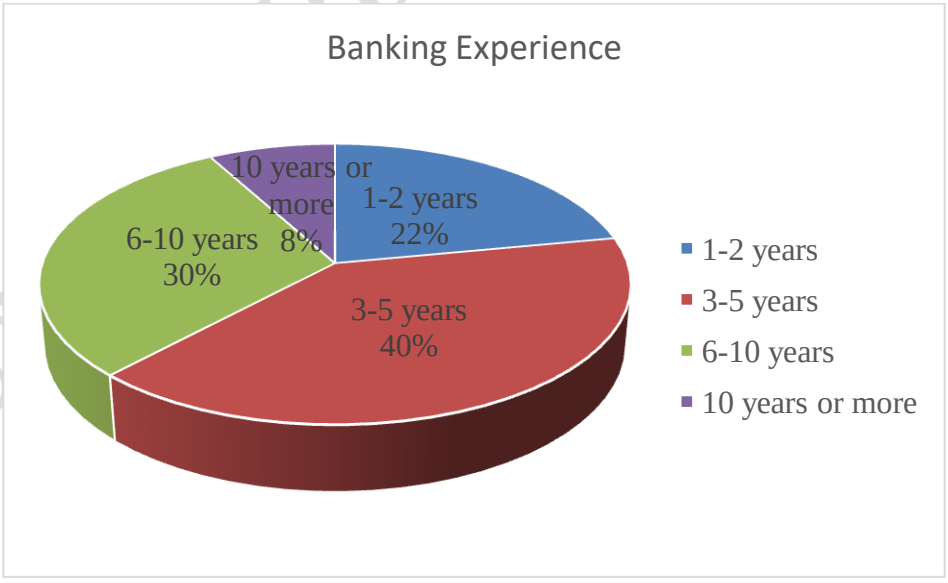

Figure 4 Respondents Banking Experience

4.2 Main Data Analysis

4.2.1 Type of Risk in the FBN Bank

According to Table 5 below, 18 respondents regarded credit risk as the most serious threat to the bank's operations. system risk and Operations risk come in next ranking, with 24 percent and 32 percent of respondents, respectively. The survey also revealed that Interest rate risk and liquidity risk have less impact on FBN bank because the banks benefit more during periods of high interest rates and may choose to lower loan and advance amounts during periods of poor liquidity. As a result, only a small fraction of respondents believes the bank is vulnerable to them.

Table 5 The type of risk the first bank is prone to

Types	Frequency	Percentage	Cumulative percentage
Valid credit risk	18	36.0	36.00
Interest rate risk	01	02.0	38.00
Liquidity risk	03	06.0	44.00
Operation risk	16	32.0	76.00
System risk	12	24.0	100.00
Total	50	100	

Source: field survey, 2021

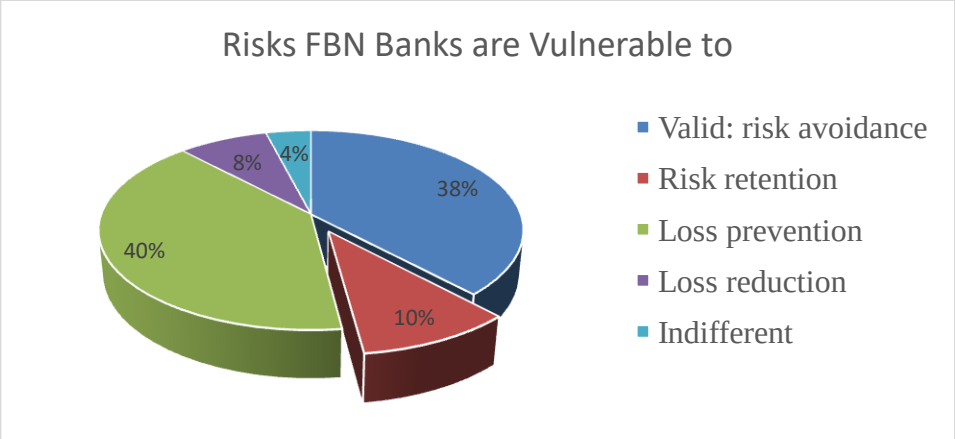

Figure 5: Pie-chart distribution of FBN Banks vulnerable risks

4.2.2 Methods Used by Bank to Hedge Against Risk

According to the data shown in Table 6 below, 38 percent of respondents chose risk avoidance, 10 percent chose risk retention, and 40 percent chose loss prevention as the various ways utilized in the bank to hedge against risk. Only 8% of those polled chose loss reduction as a risk management strategy. As a result, loss prevention is the most widely utilized type of risk hedging in the banking industry, followed by risk avoidance.

Table 6 Various methods used by banks to hedge against risk

Feedback	Frequency	Percentage	Cumulative percentage
Valid: risk avoidance	19	38.0	38.00
Risk retention	05	10.0	48.00
Loss prevention	20	40.0	88.00
Loss reduction	04	08.0	96.00
Indifferent	02	04.0	100.00
Total	50	100	

Source: field survey, 2021

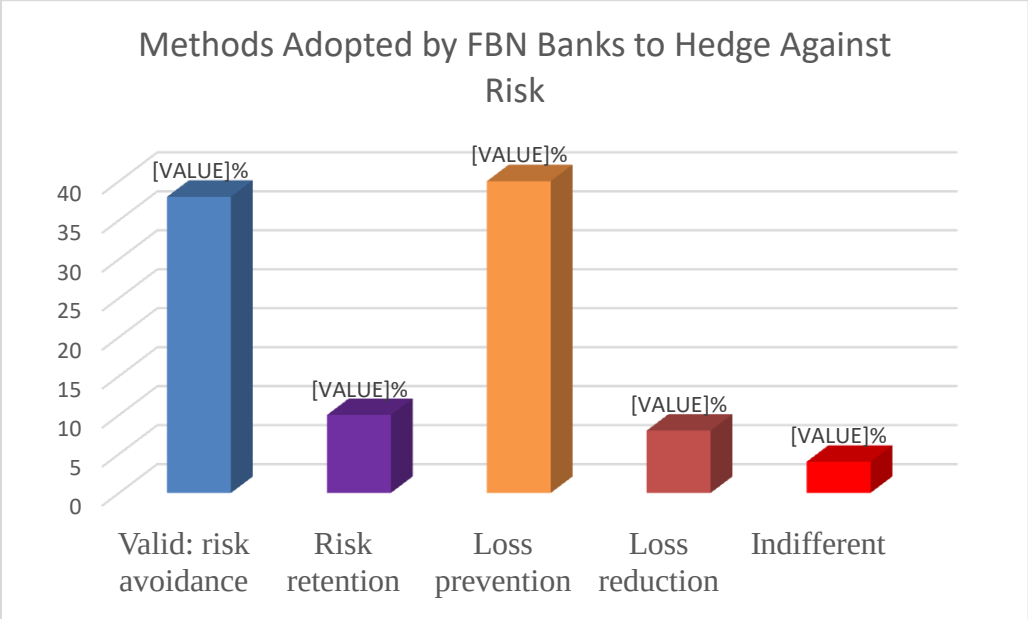

Figure 6: Histotrophic Representation of Methods Adopted by FBN Banks to Hedge Against Risks

4.2.3 Risk Exposures in the FBN Bank

According to Table 7 below, 70 percent of respondents strongly agree that fraud and forgeries add to risk exposures in the banking business, whereas 24 percent agreed. Conversely, only 4% and 2% of respondents were indifferent and disagreed with the premise, respectively. As a result, we can conclude that fraud and forgeries play a crucial role in the FBN banking industry's risk exposure

Table 7 Whether Fraud and Forgeries contribute to risk exposures in banks

Feedback	Frequency	Percentage	Cumulative percentage
Valid: SD	00	0.0	00.00
D	01	02.0	02.00
I	02	04.0	06.00
A	12	24.0	30.00
SA	35	70.0	100.00
Total	50	100	

Source: Researchers Field Survey, 2021

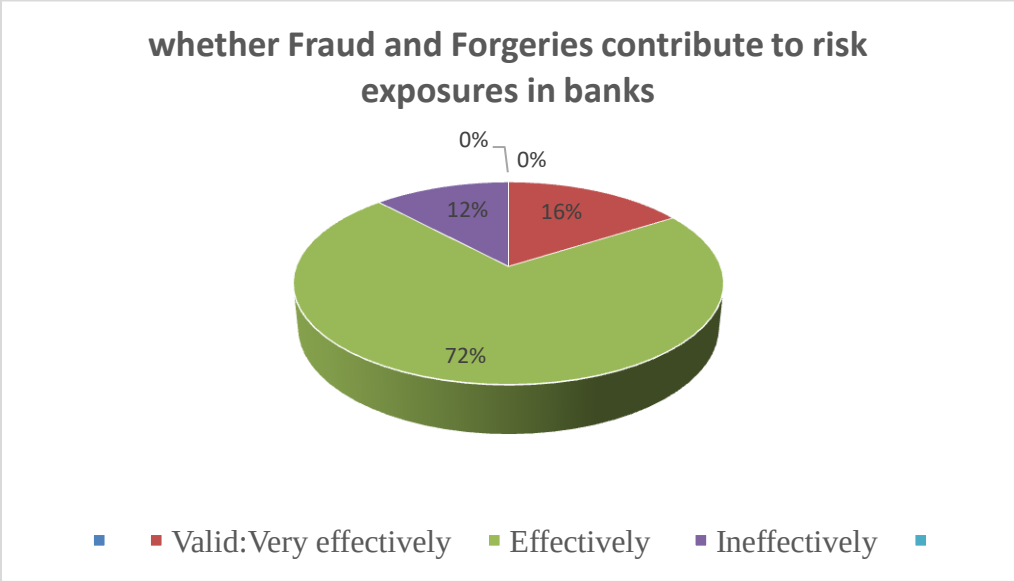

Figure 7: Graphical Percentage Representation of Fraud and Forgeries Contribution to Risk Exposures in Banks

4.2.4 Attitudes Factor in the FBN Bank

According to the Table8 below, 16 percent of the respondents strongly agreed with the assertion that borrowers' attitudes toward loan repayment are a risk factor for banks, and 70 percent agreed with the statement. However, 2% of respondents disagreed with the assertion, while the remaining 8% were indifferent.

Table 8 whether borrowers' attitudes towards loan repayment are a risk factor for the bank

Feedback	Frequency	Percentage	Cumulative percentage
Valid: SD	02	04.0	04.00
D	01	02.0	06.00
I	04	08.0	14.00
A	35	70.0	84.00
SA	08	16.0	100.00
Total	50	100	

Source: field survey, 2021

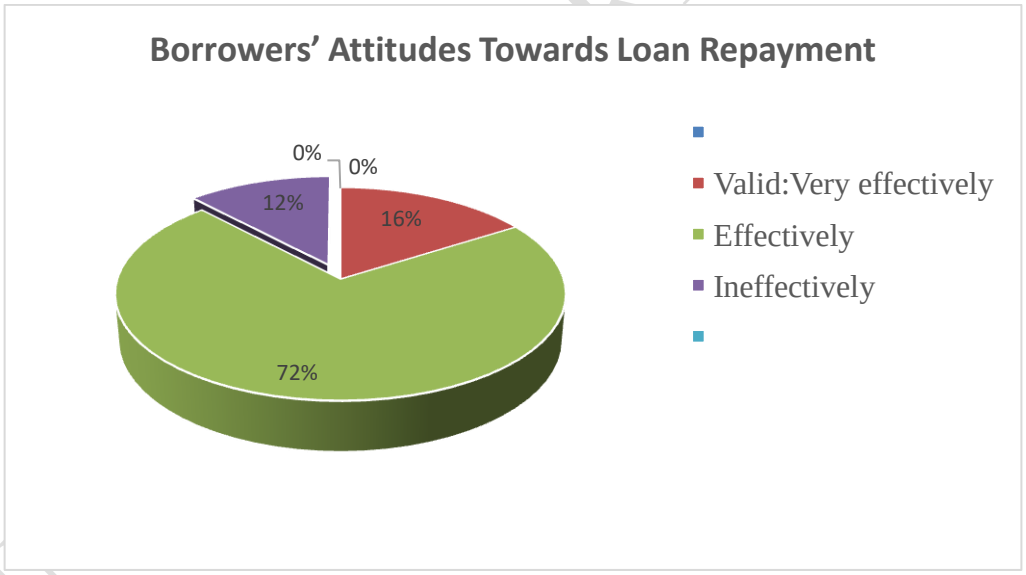

Figure 8 Pie Chart of Borrowers Attitudes Towards Loan Servicing

4.2.5 Risk Management Techniques in the FBN Bank

Table 9 below shows how well the bank's various risk management approaches have worked to mitigate the various operational risks it faces. Only 12% chose ineffectively, whereas 16% choose very effectively, 72% chose effectively, and 60% chose very effectively. This demonstrates that the numerous risk management approaches implemented by first bank's management have aided in reducing the bank's operational hazards effectively.

Table 9 Whether the risk management techniques put in place have curbed the various operational risk in the bank

Feedback	Frequency	Percentage	Cumulative percentage
Valid:Very effectively	08	6.0	16.00
Effectively	36	72.0	88.00
Ineffectively	06	12.0	100.00
Total	50	100	

Source: Field Survey, 2021

The brown upward sloping line from figure 9 shows the pareto line and it can be concluded that FBN bank possesses the requirements and criteria's for assessing operational risk. However, the FBN bank still needs to improve existing risk control systems in use.

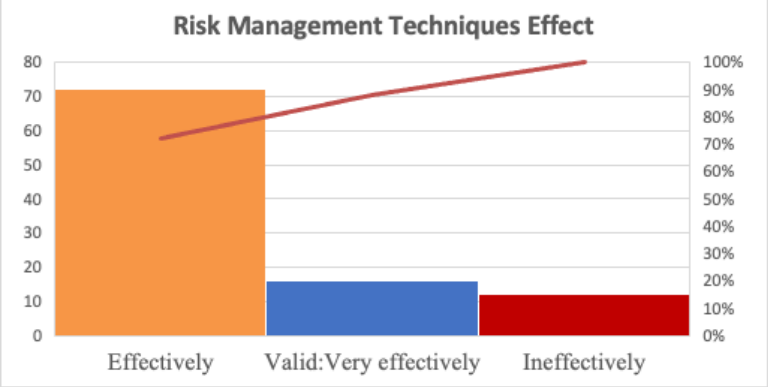

Figure 9: Histogram Representation of Risk Management Techniques Effectiveness on Various Operational Risks in the Bank

4.3 Impact of Operational Risk on FBN Bank's Stability

The hypothesis of the study was tested using the multiple regression analysis statistical technique with a significance threshold of 5%.

H0: Operational risk management has no substantial positive relationship with FBN banks financial stability' using ROE in Nigeria.

H1: Operational risk management has substantial positive relationship with FBN banks' financial stability' using ROE in Nigeria.

Using ROE = $\beta 0 + \beta 1$ BNPL + $\beta 2$BROCI, + $\beta 3$BRTL +ε

4.3.1 Regression Result

From table 10 Operational risk management has a shared significant link with return on equity of the FBN banks in Nigeria. According to the regression results in table 10 bank ratio of non-performing loan (BNPL) has a strong negative relationship and significant negative impact on return on equity at (1=-0.585692), p=0.0074 less than 5% level. Therefore, a percentage increase in bank ratio of nonperforming loans (BNPL) would result to 58% decrease in return on equity (ROE). This follows the extreme value theory which can be used to explain the behavior of tips (Maxima) and or dips (Minima) in a series of asset returns, among other things.

The result also reveals that the bank non-performing loan to total loan ratio and cost to income ratio of FBN banks have a negative significant association with return on equity (2=-0.2590), p=0.0438 respectively). This is consistent with the predictions, indicating that a percentage rise in operational costs will result in a 0.2590 percent decrease in (ROE) return on equity, respectively. This study backs up Adegbie Folajimi Festus and David Olumuyiwa Sunday (2020) conclusion that the percentage of non-performing loans to total loans, as well as the ratio of operational costs to operating revenue, have a significant negative impact on banks' return on equity and earnings per share in Nigeria. Furthermore, the findings of Elkelish (2015). Non-performing loans to net total loans ratio and cost to income ratio have negative substantial effects on return on equity.

In contrast, the findings revealed that the total loan and advances to total deposit ratio of banks had a positive but insignificant association with the return on equity of selected deposit money institutions in Nigeria ($p > 0.05$) (3= 0.237, t-test= 0.788). This also means that a bank's total loan and advances to total deposit ratio isn't a key element in determining changes in return on equity in FBN’s deposit money institutions.

This indicates that the total bank loans and advances to total deposit ratio did not meet a priori assumptions. This study also contradicts Saifu's (2019) findings, which indicated that the loans-

to-deposit ratio had a positive significant link with Indonesian banks' return on equity. The data did not confirm the findings of Yousfi (2014), who claimed that utilizing return on asset, the ratio of loans and advances to total deposit has a negative and significant effect on profitability.

Table 10 Regression Result

Variables	Coefficients	T-stat	Probabilities
C	3.671328	0.404647	0.0427
BNPL	-0.585692	-4.338601	0.0074
BROCI	-0.259033	-0.270179	0.0438
BRTL	0.624715	1.204620	0.2823
R-Squared	0.853543		
Adjusted R-Squared	0.765669		
Prob(F-Statistic)	0.015821		
Durbin-Watson stat	2.020069		

Dependent variable: ROE *significant at 5%

4.3.2 The Durbin Watson Statistics

A test for autocorrelation in residuals from a statistical model or regression study is the Durbin Watson (DW) statistic. Nevertheless, the decision rule is that a number between 0 and 4 will always be assigned to the Durbin-Watson statistic. A score of 2.0 implies that the sample contains no autocorrelation. Positive autocorrelation is defined as a value between 0 and less than 2, whereas negative autocorrelation is defined as a value between 2 and 4. Therefore

Durbin-Watson state shows 2.120069 which insinuates that there is no autocorrelation in the regression model.

4.3.3 Variation and Fitness of the Model

R-squared (R2) is 85 percent, this is a statistical measure that quantifies the proportion of variation explained by the operational risk management measures or variables in the regression model for the financial stability (ROE) variable measure.

Following, the Adjusted R2, which measures the proportion of changes in return on equity of FBN banks as a result of changes in non-performing loan to total loan ratio, cost to income ratio, and total loan and advances to total deposit ratio of the banks, explains about 76% of changes in return on equity of FBN banks in Nigeria, with other factors accounting for the remaining 24 percent.

1.1 Recommendations and Contributions

As operational risk has a negative influence on the return on equity ratio, banks should manage it properly. As a result, banks should adhere to the laws governing credit facilities, as non-performing loans jeopardize their financial viability and also makes them vulnerable. Banks should implement proper laws and fines in managing their loan portfolio and operational costs in order to improve financial stability. Finally, because of the negative effects on return on equity, the study also suggests that operational risk management be improved. This is because potential investors are unlikely to participate in a business where non-performing loans and high operating costs will erode their money. FBN bank should upgrade its risk indicator systems or infrastructure to reduce the systemic risk that FBN banks face. This would also keep the system from malfunctioning or failing.

Finally, the FBN bank should use a risk-based management approach that adheres to international norms and focuses on the financial and operational risks that banks confront. Overall, FBN banks should also establish inspection departments to do internal checks and prevent operational issues.

In order to ensure financial system stability, the report also offers information that could aid financial regulators in developing new rules and frameworks and revising existing policies and frameworks on operational risk management methods. The study's findings supported the hypothesis that extreme value theory is a useful tool for analyzing activities, or financial risks

that could result in large operational risk losses for financial institutions, and that risk theory of profit is a useful indicator for managers in determining earning capacity in relation to risk exposure.

The study also acts as a resource for academics interested in operational risk management and provides a foundation for future research.

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