

**EFFECT OF RISK MANAGEMENT PRACTICE ON COMMERCIAL BANKS
A CASE STUDY OF FIRST BANK PLC**

BY

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KEFFI, NIGERIA.**

JANUARY, 2020

DECLARATION

I declare that this research work titled “Effect of Risk Management practice on Commercial Banks. A study of First Bank Plc, Nasarawa State” has been conducted and compiled by me.

All quotations, references and materials consulted have been acknowledged in the bibliography.

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DATE

CERTIFICATION

This is to certify that this research work titled “Effect of Risk Management practices on Commercial Banks: A case study of First Bank PLC, meet the regulations governing the award of Post Graduate Diploma in Business Administration (PGD) Nasarawa State University, Keffi and approved for its contribution to knowledge and literacy presentation.

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DEDICATION

This research work is dedicated to God Almighty, my late father Mr Zaphaniah and my son Mr Michael Christopher.

ACKNOWLEDGEMENT

My profound appreciation goes to Almighty God for his blessing and favour onto me and my appreciation goes to my project supervisor Dr. S. M. Aza for his untiring assistance and advice given to me throughout my study and in the course of writing this project.

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ABSTRACT

This research work examines risk management in banking industry with particular reference to First Bank of Nigeria PLC. The researcher's uses the primary and secondary data in order to arrive at relevant information. In this research work the researcher set up four hypotheses in order to test the problem under study. The study recommends that Commercial banks in Nigeria should adopt best practices in managing the risk associated with information system, Banks in Nigeria should have better lending skills and able to engage in arms-lending and resist government pressures, and potentially impose fewer demands on government for bailouts than the intermediaries they replaced, The banking reform should rely mostly on interest rate operating procedures for macroeconomic management with the sole objective of moving towards the 'law of one market' in both the domestic and international money markets.

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CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The past decades has seen dramatic losses in the Banking industry. Firms that had been performing well suddenly announced large losses due to credit exposures that turned sour, interest rates positions taken, or derivative exposure that may or may not assumed to hedge balance sheet risk. In response to this, commercial banks have also universally embarked upon and upgraded their risk management and control system, (Babble, 2000).

Because of our recognition of the industry's vulnerability to financial risk, the Wharton financial institution center, with the support of the Sloan foundation, has been involved in an analysis of financial sector. Through the past academic year, on-site visit were conducted to review and evaluate the risk management system and the process of risk evaluation system that is in place. In the banking sector, system evaluation was conducted covering many of North America's super regional and quasi-money centre commercial banks, as well as a number of major investment banking firms, (Fallons, 2001).

This intermediation role of banks in a country with an estimated population of 160 million inhabitants, make it very important for the banks to develop or acquire, install, deploy and maintain top rated information system in their daily operations. The systems so deployed are expected to be fluid, in order to be adaptable to changing current and future operational needs.

However, Nigeria being a developing country lacks the basic technology and other infrastructures required to support a vibrant banking sector. There is therefore a

compelling need to properly review the characteristics and adaptability of information systems packages to ensure that only those that can well meet the needs of the country's financial industries are required. Berger, (2003)

In order to effectively harness the benefit of any deployed Information Technology (IT) system, there is need for management to define standards and goals it expect to achieve by means of the technology so acquired. Some commercial banks, for example, depend on outsourcing for their information systems. This is due to the fact that IT is a special field, new, technical and outside the basic scope of core retail banking. However, success in banking itself could depend; to a larger extend, on the ability of the given organization to manage the risk associated with outsourced information systems. Bhattasharya, (2000)

Most research carried out in this context has focused more on America, few European countries, Japan etc (Altman, 2003). Little or no formal research work has been done in understanding the outsourcing trend in Nigeria and, in particular, in gaining a clear understanding of the risk management practices adopted by banks. It is certain that the use of information system outsourcing is on the increase in Nigeria, as exemplified in the outsourcing decisions made by most banks.

Banks are link to economic development through the financial service they provide. Their intermediation role can be said to be a catalyst for economic growth. The efficient and effective performance of the banking industry over time is an index of financial stability in any nation. The extent to which a bank extends credit to the public for productive activities accelerates the pace of a Nation's economic growth and its long-term sustainability.

The credit function of banks enhances the ability of investors to exploit desired profitable ventures. Credit creation is the main income generating activity of banks (Kargi, 2013). However, it exposes the banks credit risk. The Basel committee on banking supervision (2001) defined credit risk as the possibility of losing the outstanding loan partially or totally, due to credit events (default risk). Credit risk is an internal determinant of bank performance. The higher the exposure of a bank to credit risk, the higher the tendency of the bank to experience financial crisis and vice-versa.

Among other risk faced by banks, credit risk plays important role on bank's profitability since a large chunk of bank's revenue accrues from loans from which interest is derived. However, interest rate risk is directly linked to credit risk which implies that high or increment in interest rate increase the chances of loan default. credit risk or interest rate risk are intrinsically related to each other and not separable (Drehman, Sorensen, and Stringa, 2008). Increasing amount of non-performing loans in the credit portfolio is inimical to banks in achieving their objectives.

Non-performing loan is the percentage of loan values that are not serviced for three months and above (Ahmad and Ariff, 2007).

Due to the increasing spate of non – performing loans, the Basel II Accord emphasized on credit risk management practices. Compliance with the Accord means a sound approach to tackling credit risk has been taken and this ultimately improves bank performance. Through the effective management of credit risk exposure, banks not only support the viability and profitability of their own business, they also contribute to systemic stability and to an efficient allocation of capital in the economy (Psillaki Tsolas, and Margaritis, 2010).

The Nigerian banking industry has been strained by the deteriorating quality of its credit assets as a result of the significant dip in equity market indices, global oil prices and sudden depreciation of the naira against global currencies (BGL Banking Report, 2010). The poor quality of the bank's loan assets hindered banks to extend more credit to the domestic economy, thereby adversely affecting economic performance. This prompted the Federal Government of Nigeria through the instrumentality of an Act of the National Assembly to establish the asset management corporation of Nigeria (AMCON) in July, 2010 to provide a lasting solution to the recurring problem of non-performing loans that bedeviled Nigerian banks. According to Ahmad and Ariff, (2007), most bank in economies such as Thailand, Indonesia, Malaysia, Japan and Mexico experienced high non-performing loans and significant increase in credit risk during financial and banking crises, which resulted in the closing down of several banks in Indonesia and Thailand.

1.2 Statement of the Problem

Most banks have resolved to use different sources of information technology providers such as outsourcing, off-shoring and contracted service providers in meeting their critical needs. Most organizations see it as a way of spending resources wisely. Outsourcing, off-shoring and contracted services are possible ways in which banks can drive down cost while outsourcing for its processes. The problem identified in this study cu across the banking system, relating to the Central Bank, other regulatory agencies, operating banks, their shareholders, bank employees and other stakeholders in the banking industry.

Each of the afore-mentioned sources has its downside because there are evidences of information management failures and unsatisfactory performance of information

systems acquired by some commercial banks in Nigeria whether by off-shoring or by using a service provider, outsourcing totally or selectively.

1.3 Statement of Objectives

The broad objective of the study is to appraise the efficiency and effectiveness of credit risk management in commercial banks in Nigeria.

The specific objectives are to:

Examine the relevance of risk management procedures in a commercial bank.

Identify risk management practices currently adopted in commercial banks in Nigeria.

Examine the impact of risk management practices currently adopted by commercial banks in Nigeria.

Ascertain the adequacy of currently adopted risk management practices and exposes major inadequacies of such practices.

Proffer possible policy recommendation to the study.

1.4 Research Questions

Based on the problems identified for this study, the following questions now emerge:

What is the relevance of risk management procedures in a commercial bank?

What are the risk management practices currently adopted in commercial banks in Nigeria?

What impact does risk management practices currently adopted make on commercial banks in Nigeria?

Does the adequacy of currently adopted risk management practices expose major inadequacies of such practices?

1.5 Statement of Hypotheses

In order to achieve the objectives, the following hypotheses are formulated as follows:

Ho1: there is no significant relationship between credit risk management and banking operations.

Ha1: there is a significant relationship between credit risk management and banking operations.

Ho2: credit risk management does not contribute positively to banking industry's profitability in Nigeria.

Ha2: credit risk management contributes positively to banking industry's profitability in Nigeria.

1.6 Significance of the Study

The study will help business analyst, financial and human resources consultants, financial institutions, bankers and professionals alike to improve in their analytical, consulting and operational strategies to boost their client's performance to minimize risk in order to avoid the rippling effects that goes with it.

Policy makers will find the study relevant because it will help in formulating policies on the banking sector and also in advising government in an efficient and effective way by which policy formulated will be implemented. Government will also benefit from the study because it will guide in effective policy to implement in banking sector reforms and consolidation in Nigeria. It is recognized that like other analysis, this is of value to policy and decision makers, leaders in private and public sectors, and as a basis for developing appropriate policy and decision making particularly for economic growth and development.

Stakeholders will find this study very relevant and important because it will assist them in their deliberations and discussions on the effects and consequence of credit risk management in commercial banks and in proffering possible policy recommendations that will help both the government and the administrators of

policies. It is recognized that like other analysis, this is of value to policy and decision makers, leaders in private and public sectors, and as a basis for developing appropriate policy and decision making particularly for credit management and the performance of commercial banks.

1.7 Scope and Limitations of the Study

This study is on the Impact of Risk Management Practice on Commercial Banks, a case study of First Bank PLC from 2009 to 2013. The basis for covering this study is to show whether there have been any significant impact of credit risk management on banking performance.

The problem of getting the relevant textbooks, journals and other materials might pose as a threat to the quality of this research. The period given is not adequate for a study of this magnitude and also a high demand nature of other academic engagement would effects the quality of this research. For this reason the study has to be limited to some specific areas.

The non availability of finance for countless trips to collect data and meet certain obligation as at when due may contribute to the quality of this research work. Also organizations and individuals usually characterized by the fear of diverging sensitive information to outsiders.

1.8 Definition of Operational Terms

Risk Management: The process of analyzing exposure to risk and determining how to best handle such exposure.

Credit Risk: The possibility that a bond issuer will default, by failing to repay principal and interest in a timely manner.

Management: A group of individuals who make decisions about how a business is run.

Commercial Bank: An institution which accepts deposits makes business loans, and offer related services. Commercial banks also allow for a variety of deposit accounts, such as checking, savings, and time deposit.

CHAPTER TWO

LITERATURE REVIEW

2.1 Literature Review

A bank exist not only to accept deposits but also to grant credit facilities, therefore inevitably exposed to credit risk. Credit risk is by far the most significant risk faced by banks and the success of their business depends on the accurate measurement and efficient management of risk to a greater extent than any other risks (Gieseche, 2004). According to Chen and Pan (2012), credit risk is the degree of value fluctuations in debt instruments and derivatives due to changes in the underlying credit quality of borrowers and counterparties. Coyle (2000) defines credit risk as losses from the refusal or inability of credit customers to pay what is owned in full and on the time. Credit risk is the exposure faced by banks when a borrower (customer) defaults in honouring debt obligations on due date at maturity. This risk interchangeable called 'counterparty risk' is capable of putting banks in distress if not adequately managed. Credit risk management maximizes bank's risk adjusted rate of return by maintaining credit risk exposure within acceptable limit in order to provide framework for understanding the impact of risk management on bank's profitability (Kargi, 2013). Demirguc-Kunt and Hazinga (1999) opined that credit risk management is in two-fold which includes, the realization that after losses have occurred, the losses becomes unbearable and developments in the field of financing commercial paper, securitization, and other non-bank competition which pushed banks to find viable loan borrowers.

The main source of credit risk include, limited institutional capacity, inappropriate credit policies, volatile interest rates, poor management, inappropriate laws, low capital and liquidity levels, direct lending, massive licensing of banks, poor loan

underwriting, laxity in credit assessment, poor lending practices, government and inadequate supervision by the central bank (Kitthinji, 2010). An increase in credit risk gradually leads to liquidity and solvency problems. Credit risk may increase if the bank lends to borrowers, it does not have adequate knowledge about.

2.2 Historical Background and Organizational Structure of First Bank Plc

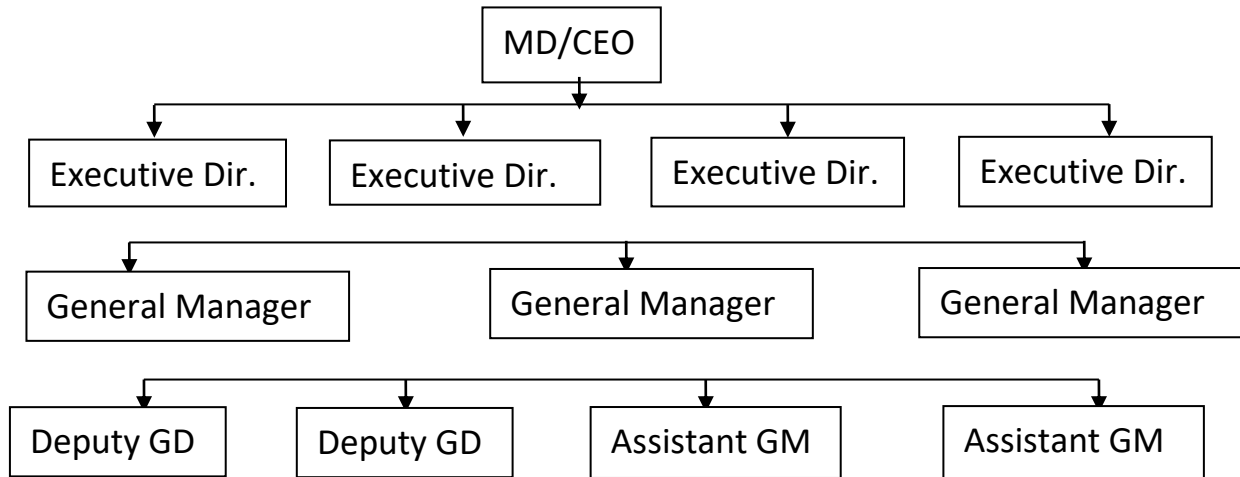
First Bank Plc began operations in 1901 with the name Standard bank. Later, it changed to First Bank Plc, with full commercial banking and then became a universal bank. First Bank is today ranked amongst the top 10 in the Nigerian Banking industry, with presence in the major cities and commercial centre's of Nigeria.

Over the years, the bank has been reputed for integrity and professionalism. It is also respected for the quality and stability of its management. First staffs are also respected in the Nigerian banking industry for the quality of training they receive on the job, as well as in business schools both in Nigeria and Overseas. The Management is particular about the quality of people that join the system. To qualify as a member of team, a candidate is expected to possess three vital statistics, with the acronym TAC: Talent (an innate mental aptitude Ambition (a desire to succeeds) and Character (a total quality of integrity which will guide the talent and ambition to productive ends). The management is focused on building and maintaining a virile and well respected brand that caters to the needs of its growing corporate, commercial and consumer banking, clientele. For this purpose, the bank is leveraging its pedigree in investment banking (Fidelity was a merchant bank for 11 years) and its structures and service offering for the retail populace.

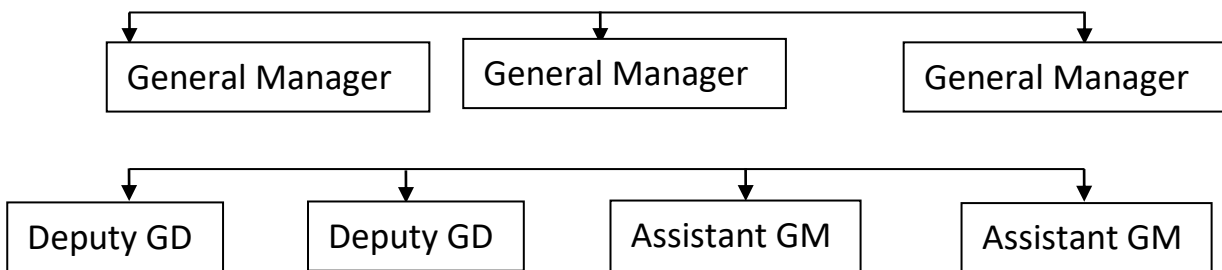
First Bank also enjoys the respect and partnership of the network of offshore institutions with which it has corresponding banking, confirmation lines, credit and

other relationships. These include, ANZ London, Afrexim bank, Cairo Egypt, ABSA South Africa, Commercial Bank, Frankfurt, Citibank, N.A London and New York, FBN Bank, UK Ltd, SCB, London, HSBC, US Ex-im Bank, USAID, etc.

Organizational Structure of First Bank Plc



SUBSIDIARIES



2.3 Conceptual Framework

It should now be clear that it is important to know about the concept of risk, in order to be able to manage risks associated with information systems outsourcing more effectively. Risk is examined from different views: the definition of risk and types, information systems, information systems strategy and information systems outsourcing, evaluation and adoption process of vendors, risk management and its practices and finally mitigation.

These are as follows:

“... a measure of the probability and severity of adverse effects .” (Froot, 2003).

“... the likelihood of adverse events associated with bad consequences.” Furash, (2004).

“... potential failure point.” (Morsman, 2003)

The above definitions are simplified and do not address issues such as the events in which these risks occurs. In addition all the definitions are based on negative outcomes.

Jorion, (2002) took a wider scope when they described risk as “the occurrence of an event that has consequences for, or impacts on projects.” The British Royal Society, (1983) further extended the definition of risk to include “the probability that a particular adverse event occurs during a stated period of time, or result from a particular challenge.”

Noteworthy, therefore, is the fact that the outcomes of risk on projects are not always negative since a “risk may hinder or help a project.” (Ahmad, 2007), and uncertainties may result in adverse variations of profitability of losses, Ahmad, (2007).

This research considers the concept and complexion of risk with a view to understanding the effects in streamlining and optimizing an information system outsourcing process. The process of risk assessment and management in outsourcing is focused on the risk of achieving the benefits, the necessary timing, and the optimal use of resources as well as the problems associated with changeover of systems. It is therefore important to look at the types of risks from a broad view.

Commercial banks are in the risk business. In the process of providing financial services, they assume various kind financial risks. Over the last decade our understanding of the place of commercial banks within the financial sector has improved substantially. The risks contained in the bank’s principal activities, i.e., those involving its own balance sheet and its basic business of lending and borrowing,

are not all borne by the bank itself. In many instances the institution will eliminate or mitigate the financial risk associated with a transaction by proper business practices; in others, it will shift the risk to other parties through a combination of pricing product design. Ahmed (2008)

The banking industry recognizes that an institution need not engage in business in a manner that unnecessary impose risks upon it; nor should it absorb risk that can be efficiently transferred to other participants. Rather it should only manage risks at the firm level that more efficiently managed than by the market or by their owners in their own portfolios. In short, it should accept only those risks that are uniquely a part of bank's array of services. Oldfield (2007) argued that risks facing all financial institutions can be segmented into three separable types, from a management perspective.

Risk that can be eliminated or avoided by simple business practices.

Risk that can be transferred to other participants, and Risk that can be must be actively managed at the firm level.

In the first of these cases, the practice of risk avoidance involves actions to reduce the chances of idiosyncratic losses from standard banking activity by eliminating risks that are superfluous to the institution's business purpose. Common risk avoidance practices here include at three types of actions. The standardization of process, contracts and procedures to prevent inefficient or incorrect financial decisions is the first of these. The construction of portfolio that can benefit from diversification across borrowers and that reduce the effects of any loss experience is another. This point has been made in a different context by Berger (2003).

There are also some risks that can be eliminated, or at least substantially reduced through technique of risk transfer. Markets exist for many of the risk borne by the banking firm. Interest rate risk can be transferred by interest rate products such as swaps or other derivatives. Borrowing terms can be altered to effect a change in their duration. Finally, the bank can buy or sell financial claims to diversify or concentrate the risks that result in from servicing its client base. To the extent that the financial risks of the assets created by the firm are understood by the market, these assets can be sold at their fair value. Unless the institution has a comparative advantage in managing the attendant risk and/or desire for the embedded risk contain, there is no reasons for the bank to absorb such risks rather transfer them. Busari, (2008).

However, there are two classes of assets or activities where the risk inherent in the activity must and should be absorbed at the bank level. In these cases, good reasons exist for using firm resources to manage bank level risk. The first of these includes financial assets or activities where the nature of the embedded risk may be complex and difficult to communicate to third parties. This is the case when the bank holds complex and proprietary assets that have thin, if not non-existent, secondary markets.

Communication in such cases may be more difficult or expensive than hedging the underlying risk. Moreover, revealing information about the customer may give competitors an undue advantage. The second case included proprietary positions that are accepted because of their risks, and their expected return. In all such circumstances, risk is absorbed and needs to be monitored and managed efficiently by the institution. Only then will the firm systematically achieve its financial performance goal. Bhattacharya, (2000).

It seems appropriate for any discussion of risk management procedures to begin with why these firms managed risk. According to standard economic theory, managers of value maximizing firms ought to maximize expected profit without regard to the variability around its expected value.

In fact, the recent review management reported in Santomero (2005) lists dozens of contributions to the area and at least four distinct rationales offered for active for risk management. These include managerial self interest, the non-linearity of the tax structure, the costs of financial distress and the existence of capital imperfections. Anyone of these justified the firms' concerned over return variability, as the above-cited authors demonstrate.

After reviewing the procedures employed by leading firms, and approach emerges from an examination of large-scale risk management systems. The management of the banking firm relies on a sequence of steps to implement a risk management system.

2.4 Credit Risk Management Strategies

The credit risk management are measures employed by banks to avoid or minimize the adverse effect of credit risk. A sound credit risk management framework is crucial for banks so as to enhance profitability and guarantee survival. According to Lindergren (1987), the key principles in credit risk management process are sequenced as follows; establishment of a clear structure, allocation of responsibility, processes have to be prioritized and disciplined, responsibilities should be clearly communicated and accountability assigned. The strategies for hedging credit risk include but not limited to these:

Credit Derivatives: this provides banks with an approach which does not required them to adjust their loan portfolio. Credit derivatives provide banks with a new source

of fee income and other banks the opportunity to reduce their regulatory capital (Shao and Yeager, 2007). The commonest type of credit derivative is credit default swap whereby a seller agrees to shift the credit risk of a loan to the protection buyer. Frank Partnoy and David Skeel in financial times of 17th July, 2006 said that “credit derivatives encourage banks to lend more than they would, at lower rates, to riskier borrowers”. Recent innovations in credit derivatives markets have improved lenders abilities to transfer credit risk to other institutions while maintaining relationship with borrowers (Marsh, 2008).

Credit Securitization: it is the transfer of credit risk to a factor of insurance firm and this relieves the bank from monitoring the borrower and fear of the hazardous effect of classified assets. This approach insures the lending activity of banks. The growing popularity of credit securitization can be put down to the fact that banks typically use the instrument of securitization to diversify concentrated credit risk exposures and to explore alternative source of funding by realizing regulatory arbitrage and liquidity improvements when selling securitization transactions (Michalak and Uche, 2009). A cash collateralized loan obligation is a form of securitization in which assets (bank loan) are removed from a bank’s balance sheet and package (tranche) into marketable securities that are sold on to investors via special purpose vehicle (SPV) (Marsh, 2008).

Compliance to basel accord: the basel accord are international principles and regulations guiding the operations of banks to ensure soundness and stability. The accord was introduced in 1988 in Switzerland. Compliance with the accord means being able to identify, generate, track and report on risk-related data in an integrated manner, with full auditability and transparency and creates the opportunity to improve the risk management processes of banks. The New Basel Capital Accord places

explicitly the onus on bank to adopt sound internal credit risk management practices to assess their capital adequacy requirements (Chen and Pan, 2012).

Adoption of a sound internal lending policy: the lending policies guide banks in disbursing loans to customers. Strict adherence to the lending policy is by far the cheapest and easiest method of risks management. The lending policy should be in line with the overall bank strategy. Factors considered in designing a lending policy should include; the existing credit policy, industry norms, general economic conditions of the country and prevailing economic climate (Kithinji, 2010).

Credit Bureau: this is an institution which compiles information and sends this information to banks as regards the lending profile of a borrower. The bureau awards credit score called statistical odd to the borrower which makes it easy for the banks to make instantaneous lending decision. Examples of a credit bureau are the Credit Risk Management System (CRMS) of the Central Bank of Nigeria (CBN).

2.5 Risks in Providing Banking Services

The risks associated with the provision of banking differ by the type of services rendered. For the sector as a whole, however, the risks can be broken down into six generic types: *systematic or market risk, credit risks, counterparty risk, liquidity risk, operational risk and legal risk*.

Systematic risk is the risk of asset value change associated with systematic factors. It is sometimes referred to *market risk*, which is in fact a somewhat imprecise term. By its nature, this risk can be hedged, but cannot be diversified completely away. In fact, systematic risk can be thought as undiversifiable risk. Santomero, (2006).

All investors assume this type of risk, whenever assets owned or claims issued can change in value as a result of broad economic factors. As such systematic risk comes

in many different forms. For the banking sector however, two are of greatest concern, namely variations in the general level of interest rates and the relative value of currencies. Because of the bank's dependence on these systematic sectors, most Banks try to estimate the impact of these particular systematic risks on performance, attempt to hedge against them and thus limit the sensitivity to variations undiversifiable factors.

Accordingly, most Banks track interest rate closely. They measure and manage the firm's vulnerability to interest rate variation, even though they cannot do so perfectly. At the same time, international banks with large currency position closely monitor their foreign exchange risk and try to manage, as well as limit, their exposure to it. Smith, (2000).

In a similar fashion, some institutions with significant investments in one commodity such as oil, through their lending activity or geographical franchise, concern themselves with commodity price list. Others with high single-industry concentrations may monitor specific industry concentration risk as well as the forces that affect the fortunes of the industry involved.

Credit risk arises from the non-performance by a borrower. It may arise from either an inability or an unwillingness to perform in the pre-committed contracted manner. This can affect the lender holding the loan contract, as well as other lenders of the creditor. Therefore, the financial condition of the borrower as well as the current value of any underlying collateral is of considerable interest to the bank. Saunders, (2006).

The real risk from credit is the deviation of portfolio performance from the expected value. Accordingly credit risk is diversifiable, but difficult to eliminate completely.

This is because a portion of the default risk may, in fact, result from systematic risk outlined above. In addition, the idiosyncratic nature of some portion of these losses remains a problem for creditors in spite of the beneficial effect of diversification on total uncertainty. This is particularly true for bank that lend in local markets and ones that take highly illiquid assets. In such cases, the credit risk is not easily transferred and accurate estimates of losses are difficult to obtain. Stultz, (2004).

Counterparty risk comes from non-performance of a trading partner. The non-performance may arise from counterparty's refusal to perform due to an adverse price movement caused by systematic factors, or from some other political or legal constraint that was anticipated by the principals. Diversification is the major tool for controlling non systematic counterparty risk. Al-Khour, (2003).

Legal risks are endemic in financial contracting and are separate from the legal ramifications of credit, counterparty, and operational tasks. New statutes, tax legislation, court opinions and regulations can put formerly well-established transactions into contention even when all parties have previously performed adequately and are fully able to perform in the future. For example, environmental regulations have radically affected real estate values for older properties and imposed serious to lending institutions in this area. A second type of legal risk arises from the activities of an institution's management of employees. Fraud, violations of regulations or laws, and other actions can lead to catastrophic loss, as recent examples in the thrift industry have demonstrated. Al-Khour, (2013.)

All financial institutions face all these risks to some extent. Non-principal or agency activity involves operational risk primarily. Since institutions in this case do not own the underlying assets in which they trade, systematic credit and counterparty risks

accrues directly to the asset holder. If the latter experiences a financial loss, however, legal recourse against an agent is often attempted. Therefore, institutions engaged in some banking firm and would also list regulatory and reputational risk in their sets of concerns. Nonetheless, all would recognize the first four as key, and would devote most of their task management resources to constraining these key areas of exposure. Al-Khouri, (2013.)

2.6 Bank Risk Management System

The banking industry has long viewed the problem of risk management as the need to control four of the above risks which make up most, if not all, of their risk exposure, viz. credit, interest rate, foreign exchange and liquidity risk. While they recognize counterparty and legal risks, they view them as less central to their concerns. Where counterparty risk is significant, it is evaluated using standard credit risk procedures, and often within the credit department itself. Likewise, most bankers would view legal risks as arising from their credit decisions or, more likely, proper process not employed in financial contracting. Ben-Naceur, (2008).

Accordingly, the study of bank risk management processes is essentially an investigation of how these four risks. In each case, the procedure outlined above is adopted to the risk considered so as to standardize, measure, constrain and manage each of these risks. To illustrate how this is achieved, this review of firm-level risk management begins with a discussion of risk management controls in each area. The more difficult issues of summing over these risks and adding still other, more amorphous, ones such as legal, regulatory or reputational risk, will be left to the end. Ben-Naceur, (2008).

2.7 Risk Management Policy and Strategies in Banking Industry

The fear of risk, the possibility of loss, injury, damage, peril of possibility that the actual outcome of an investment decision will not be the same as the forecasted result is inevitable in life. No aspect of human endeavour is devoid of or can escape it. It is inherent in everyday life and more so in the life of a banker. The banker's business has been and continues to be that of taking risks; which it does through maturity transformation-borrowing short and lending long. One can infer that the basis of doing this is the probability that it will not be called upon at any one time to redeem all its obligations provided it is managed prudently. This implies having adequate capital and earnings and adequate liquidity to honour its obligations as and when due. In congruous, it also means avoiding excessive risks. Risks that are taken must be compatible with profitability, liquidity and prudence (Mehran, 2004).

Thus if profitability is the foundation of banking confidence is its cornerstone. If confidence collapses or is shattered, the whole edifice collapses and so will the bankers business.

Managing risks, just managing capital and liquidity is therefore as core function of banking and this has been increasingly so in banking business for decades. The risk inherent in foreign exchange transactions is a part of the risks a banker faces. In the 1950's attention was focused on techniques for the management of bank assets, while the 1960's and 1970's emphasized liability management. However, banking in the 1980's and 1990's shifted attention to risk, how to measure risk and how to control it for the betterment of industry and its customers (Ogunleye, 2005).

Essentially the over-riding consideration of bank management is the necessity to minimize risks and maximize returns, consistent with the prudential constraints and

regulation. In reality the cardinal objective of a risk manager is to ensure that at the end of the day, he tries as much as possible to minimize his loss and maximize profit through efficient and effective management.

Saunders, (2006) posits that foreign exchange risk is probably the most involved of the banking risks. The risks involved are frequently not limited to losses due to unanticipated exchange rate changes. As each bank has to a position to meet its own foreign currency demand on time, there are liquidity risks and there are also interest rate risks; for dealings in the forward foreign exchange market. Since exchange rate movements correlate with movements in relative interest rate, a mismatched currency position and a mismatched inherent position may frequently not be independent. Accordingly, most of the instruments and techniques for addressing these other risks particularly the interest rate risk are frequently used for managing foreign currency exposure risks.

With the expansion of treasurer's business activities, the need to adequately manage the associated is becoming increasingly important. Some treasury functions today have introduced and other are planning to introduce and overall exposure monitoring and management system, able to integrate balance sheet and off balance sheet business activities. This done by consolidating all information elements relevant to risk and exposure offering a comprehensive view that facilitates control. Chen, (2012).

2.8 Interest Rate Management Procedures

The area of interest rate risk is the second area of major concern and ongoing risk monitoring and management. Here, however, the tradition has been for the banking

industry to diverge somewhat from others, (Fallon, 2001). Most commercial banks make a clear distinction between their trading activity and their balance sheet interest rate exposure. Investment bank generally has viewed interest rate risk as a classic part of market risk, and have developed elaborate trading risk management systems to measure and monitor exposure. For large commercial banks and European-type universal banks that have an active trading business, such systems have become a required part of the infrastructure. But, in fact, these trading risk management systems vary substantially from bank to bank and generally are less than imagined. In many firms, fancy value-at-risk models, now known by the acronym VaR, are up and running. But, in many cases they are still in the implementation phase. In the interim, simple adhoc limits and close monitoring substitute for elaborate real-time systems. While this may be completely satisfactory for institutions that have little trading activity and work primarily on behalf of clients, the absence of adequate trading systems elsewhere in the industry is a bit distressing.

For institutions that have active trading businesses, value-at-risk has become standard approach. This procedure has recently been publicity displayed with the release of Risk metrics by J. P. Morgan but similar systems are place at other firms. In that much exists in public record about these systems, little or no value to reviewing this technique here. Suffice it to say that the daily, weekly or monthly volatility of the market value of fixed-rate assets are incorporated into a measure of total portfolio risk analysis along with equity's market risk, and that of foreign denominated assets. Froot, (2003).

Most banks, however, have attempted to move beyond this gap methodology. They recognize that the gap and duration reports are static, and do not fit well with the dynamic nature of the banking market, where assets and liabilities change over time

and spreads fluctuate. In fact, the variability of spreads is largely responsible for the highly profitable performance of the industry over the last two years. Accordingly, the industry has added the next level of analysis to their balance sheet interest rate risk management procedures. Coyle, (2000).

Currently, many banks are using balance sheet simulation models to investigate the effect of interest rate variation on reported earnings over one-three and five-year horizons. These simulations of course are a bit of science and a bit of art. They require relatively informed reprising schedules, as well as estimates of repayments and cash flows. In terms of the first issue, such an analysis requires an assumed response function on the part of the bank to rate movement, in which bank pricing decisions in both their local and nation franchises are stimulations require precise prepayment models for proprietary products such as residential mortgages or traditional consumer debt. In addition, these simulations require yield curve simulation over a presumed relevant range of rate movements and yield curve shifts. Flurash, 2004.

Once completed, the simulation reports the resultant deviations in earnings associated with the rate scenarios considered. Whether or not this is acceptable depends upon limits imposed by management, which are usually couched in terms of deviations of earnings from the expected or most likely outcome. The notion of Earnings at Risk, EaR, is emerging as a common benchmark for the interest rate risk. However, it is of limited value as it presumes that the range of rates considered is correct, and or the bank's response mechanism contained in a simulation is accurate the feasible. Nonetheless, the results are viewed as indicative of the underlying interest rate mismatch contained in the balance sheet.

2.9 Types of Risk

Risk manifest in various forms, including having short-sighted goals, not having effective business processes, untested technologies, untested staff, loss of management commitment, political and interpersonal conflicts and even the nature fury. (Altman, 2003).

The risks presented by outsourcing systems are more than just buying and implementing these systems. Therefore, the need arises for organizations to evaluate and address the risks of outsourcing. Beyond the highly publicized traditional risk, that can affect a bank's performance, outsourcing has resulted in various types of risks and bank management should have a thorough understanding of how these risks affect banks, in order to address them appropriately. For the purpose of this research, the nature of three general business risk categories namely: strategic, operational and reputation risks will be reviewed. As Ben-Naceur, (2008) noted, management needs to compare the risks of strategy, operational and support applications in a consistent way.

2.9.1 Strategic Risks

Outsourcing activities for banks involves strategy risk because given growing customer acceptance and dependence and demand for efficient service delivery, most banks will need to develop a strategy to outsource their information systems in order to provide good services and/ or products to customers according to BGL Banking Report, (2010) strategic risks suggest that an organization is unable to sustain its distinctive competencies and competitive advantages from the use of information systems and thus leading to unfulfilled business aims. Organization is increasingly relying, on information systems to obtain strategic benefits. This reliance according to

Bhattacharya, (2000) can expose organizations to various types of risks. In order to manage strategic risks, Bhattacharya, suggested that an organization must understand them, he identified that understanding strategic risk is dependent on an organization's ability to foresee the long-term benefits from a new system, assess the resources and capabilities of its potential competitors, assess its own financial and technical strengths and align its IS strategy with its overall business strategy. BGL Banking Report, (2010) provides some home truth that strategic risk is wide in scope and will always exist. Instead an organization should provide an IS strategy that would help them focus attention on risks issues.

Losses from internal and external operational issues, pose threats to many banks. (Felix, 2008). Lopaz emphasized that external issues, are relatively easier to define than losses from internal problems. This she said happens as a result of tying the risks from internal problems to bank's specific products and business lines, thereby making them more firm specific than the risks due to external events.

The increasing interests in the banking sector's operational risks raise some questions for management – do bank managers have information systems? Do they play a role in vitiating the outsourcing risks of a bank's information systems by their involvement in the outsourcing decision process?

The complexity and advancement of banking practices brought about by factors such as technology infrastructure, security, data integrity, systems availability, internal control/audit and outsourcing, has raised a lot of concern in the banking industry, as they increase the potential for operational risks. Dimirgue-Kunt, (1999).

Altman, (2003) emphasized that a bank's operational risks seem to have only negative impacts on its financial position through the loss of valuable assets, increased

liabilities and damage to its reputation. Examples include the failures of Barings, Daiwa and Sumitomo. This takes us to the next category of risk, which is reputation risk.

2.9.2 Reputation Risk

While operational risks affect the efficiency of the enterprise and strategic risks affect its overall direction, culture, information and viability, reputation risk suggests negative publicity about a bank's information systems.

Reputation risks, according to Gieseche, (2004), can affect relationships with stakeholders, lead to expensive regulatory litigation, and impair earnings and capital. Man et al further stated that damage to the institution's reputation could occur if its information systems are not friendly or is unreasonable slow. Delays in service delivery can create concerns about the confidentiality of customer's service. System failures can also impact the banker's reputation. The institution should also have procedures in place to evaluate the information system third parties before and after outsourcing.

Marsh, (2008) in a white paper describes "reputation risk" as the loss to a bank's status if it handles a problem publicity and badly. This definition according to Marsh, (2008) report is weak for two reasons. First, the fact that too much emphasis is laid on the negative side effects with no compensatory consideration of benefit. Second, its focus is only on legal risks and it overlooks strategic and reputations effects.

Michalak, (2009) has also said that an organization's reputation is "compromised when an organization's performance, ethics or experience with stakeholders. This he said is often as a result of risks due to financial performance, corporate governance and quality management, social, ethical and environmental performance, employees

and corporate, culture. Marketing, innovation and customer relations, regulatory compliance and litigation, communication and crisis management”.

A recent study by Kithinji, (2010) showed that reputation risk is on the increase because of treats like money laundering, fraud, miss-selling, or plain lack of integrity. According to Price Waterhouse “ managing reputation risk depends on being able to respond immediately to any other risk event and handle the effect on a firm’s reputation” further to this Kithinji, (2010) argued that a blow in the reputation of a global bank can might affect the reputation of banks offering similar services.

Psillaki. (2010) opined that auditing stakeholder’s image, understanding their perception and expectations often help in reducing risk. Further, he stated that effective management of risk would help protect and enhance corporate reputation and will effectively become a core competence for an organization in a competitive world.

Shao, (2007) revealed, “There may be still be two good reasons for companies to worry about their ethical behavoiur. One is anticipation: bad companies will find more irksome than self-restraint. The other, more crucial, is trust. A company that is not trusted by its employees, partners and customers, will suffer.”

It therefore follows that managing reputation risk as suggested by Stultz, (2004) is important because “it can result in the value of the entire business eroding due to a loss of confidence by critical constituents.

2.9.3 Traditional Banking Risks

Banking risks according to Bhattacharya, (2000) is defined as adverse impacts on profitability of several distinct sources of uncertainty.” Bhattacharya, classified

banking risks as interest rate risk, market risk, credit risk, liquidity risk, operational risk, foreign exchange and other risks: country risk, settlement risk, performance risk. This research shall focus on outsourcing risks within the operational risks, which according to Bhattacharya, (2002). Usually occurs as a result of a "... malfunction of the information systems, reporting system internal risk monitoring rules and internal procedures designed to take timely corrective actions or compliance with internal risk policy rules. From the definition of operational risks, if risks are not tackled or reported some risk may never be noticed as and such not corrected which can result in adverse consequences. He classified operational risks as appearing at different levels.

2.10 Rational For Risk Management

One of the biggest sources of risk in organizations today is the need to accommodate changing requirements. Modern day businesses need to be able to modify their business processes quickly to keep up with competitors.

Basel Committee on Banking Supervision, (2001) are of the opinion that organizations need to monitor and react to the various business or strategic changes within their environment in order to survive. A number of financial disasters have been reported latterly in financial and non financial firms as well as governmental agencies. This led to the need of managing risk. To their credit, most regulatory authorities appear to recognize that the core of the problem is not derivatives per se but inadequate risk management.

In addition, there is a need for banks to meet regulatory requirements for risk measurement and capital as well as the need to have a "reliable risk measures to direct capital to activities with the best risk/reward ratios". They need estimates of the size of potential losses to stay within limit imposed by readily available liquidity, by

creditors, customers and regulators. They need mechanisms to monitor positions and create incentives for prudent risk-taking by divisions and individuals.

In his book Felix, (2008) states. “Economic uncertainty is the price that must be paid for growth.” To be successful, businesses must seek opportunities “where the forces of uncertainty and growth are the strongest.”

Some of the drivers stated by Drehman, (2008) for managing risks are:

- ✓ Technology and the internet
- ✓ Increased worldwide competition
- ✓ Free trade and investment worldwide
- ✓ Complex financial instruments, notably derivatives
- ✓ Deregulation of key industries
- ✓ Changes in organizational structures resulting from downsizing
- ✓ Reengineering and mergers
- ✓ Higher customers expectations for products and services
- ✓ More and larger mergers
- ✓ Collectively, these forces are stimulating considerable change and
- ✓ Creating an increasingly risky and turbulent business environment.

Much has been written within the information systems literature about how best risks can be managed in IT projects. Not much has been done on outsourcing in particular. Epure. (2012) provide a top-ten list of risk factors that can be used as a checklist for identifying risks that can adversely affect IT projects. Also Baccharini and Archer (2001) developed a risk assessment instrument to assess the relative level of contracting projects so that an appropriate level of effort can be applied to the management of those projects. These developments have been useful in management

of risks in organizations. More recently, Gieseche, (2004) developed a series of approach to measure the riskiness of Information System projects.

One common practice in information systems outsourcing is to call in experts or consultants to handle the process. Gujurati, (2007) referred to this as “outsourcing and outsource” and identified its advantages to include helping the clients pay for security and not having to face the consequences of taking outsourcing decisions. He suggested that companies should see risk as part of outsourcing and have a disaster recovery plan in place, which involves understanding the nature of the risks and having alternative ways of proceeding should risks associated with outsourcing. Kargi (2013) advised that services levels and contracts should be combined to ensure that a customer can always move out of a contract if the conditions in the Service level Agreement (SLA) are not met. They emphasized not only the need to make suppliers “strategic partners and not just tactical resources” but also having effective approach to change management, since organizations tend to outsource their core activities instead of the non-core activities.

Kargi, (2013) opined that the addition to service levels and contracts, there should be an agreement on problem escalation procedures, cash penalties for non performance, and incentives for superior performance, avoiding vague partnership talk and good management. The Federal Deposit Insurance Corporation of the USA also sees (SLA) as an effective tool for managing the risk associated with technology outsourcing and describes practices for measuring and monitoring service providers’ performance. FDIC believes that a “well-designed SLA will recognize and reward, or at least acknowledge, good services. It will also provide the measurement structure or performance metric- to identify substandard service and trigger correction or

cancellation provisions as warranted". It emphasized that adding incentives or penalties in the SLA can help in managing service. In the sense that if services received does not measure up to expectations, direct consequences will result. Lindgren,(1997) in an article emphasized that to have a successful outsourcing, there is the need for managers to consider the future strategic positions of the organization and the resources required to achieved it by taking the right decisions. He emphasized that managers needs to keep the resources responsible for their competitive advantage, avoid monopolistic supply market and manage post contractual agreements. By so doing they will have a greater ability to managed outsourcing risks.

2.11 Challenges of Managing Risk in Business

From the foregoing discussion of the current state of banking industry a number of issues stand out as pressing challenges confronting the industry. Broadly, these issues relate to the industry operation environment, inherent weaknesses in the conduct and practices of practitioners bordering on ethics and integrity otherwise referred to as weak corporate governance and supervisors. These issues are briefly discussed next.

It has been severally observed that the economic, socio-political and regulatory environment in which the banks operate has remained unstable (Psillaki, 2010). The major concern here is that banks are faced with increased uncertainty and inability to make long-term business plans. The economy is highly dependent on widely fluctuating income from oil. The three tiers of government exhibit unsettling fiscal indiscipline which makes monetary policies ineffective and compels monetary authorities to impose thresholds on liquidity management instruments so that are more than prudential on banks. For this reason banks are made to face a harsh regulatory regime. The banks heavily rely on public sector funds placement and also accommodate the sectors borrowing. Compounding this uncertainty is the sporadic

socio-political violence involving all times loss of lives and serious damages to already inadequate infrastructural facilities. These events which heighten threat to lives and properties, lead to loss of man-hours and add to operating cost.

2.11.1 Weak Corporate Governance

A notable feature of the industry is low ethical standard and transparency. There are manifesting in the rising cases of unwholesome practices being recorded. A number of banks engage in some sharp practices to achieve compliance with some regulatory requirements. Many banks returns provide inaccurate/misleading financial report thereby preventing timely detection of emerging problems by the supervisor. Another dimension of the weak corporate governance issue is the managerial incompetence of the top management of some as evident in weak internal control system of the banks. Substantial losses incurred by many banks on their credit portfolio, frauds and forgeries and outright negligence have brought to the fore, the importance of internal control system. Appraisals of fraud-related losses of banks examiners revealed that such losses could have been prevented had the affected banks maintained effective internal control systems. The weak internal control systems in our banks had facilitated the perpetration of frauds. Basie Committee on Banking Supervision (Shao, 2007) identified they elements of an effective internal control system to include:

- Identification of all risks run by a bank and taking appropriate steps to measure, monitor and control such risks at various levels of management;
- Maintaining an organizational structure that clearly assigns responsibility, authority and reporting relationships;
- Setting up appropriate control structure with control activities defined at every business level;

- Appropriate segregation of duties such that staff are not assigned conflicting responsibility;
- Information system should be reliable, secure and supported by adequate contingency arrangements; and
- Effective and comprehensive internal audit of the internal control system should be carried out by operationally independent, well-trained and competent staff.

2.11.2 Inadequate Legal Provisions to Handle Problem Bank and Protect Supervisors

Measured against the global practices and benchmarks, bank supervision in Nigeria still faces a number of challenges, the manner of resolution of which would definitely impact on the future of bank supervision. The significance of these challenges is demonstrated in the opinions expressed on them by the World Bank Mission on financial sector assessment which visited Nigeria in January 1999 and the IMF mission of December 2001. As part of their programmes each mission assessed the compliance of the country's bank supervisions framework with the global Basle Core Principle of effective bank supervision. Although issues noted by the missions are certainly not the only challenges confronting the supervisors. However, their resolution is strategic to shaping the future of the supervisory framework and other less disturbing problems.

Among others, both mission noted the need for legal provision to protect supervisors and prevent government interference in the discharge of their responsibilities in respect of implementation of corrective actions on failing/distressed banks. For example, providing legal protection to supervisors requires not just the enactment of the relevant legislation but some judicial structure reforms that will enable timely dispensation of litigations arising there from. The numerous cases of abuse of the

court process that bank owners have engaged in to the detriment of bank depositors where supervisory intervention is seen as not being favourable to them (bank owners). The time it takes to decide the cases of the terminally distressed banks whose owners have gone to court to challenge the revocation of their licenses by the CBN is a case in point on the inappropriateness of the existing judicial structure to provide a timely dispensation of bank related litigations and in particular those arising from supervisory intervention.

The nation regulatory/supervisory authorities have noted with serious concern the integrity problems with the data that supervisors use in particular, the significant disparity between on-site and off-site supervision data. Two main dimensions of the problem have been identified. One of the problems of lack of transparency in some banks activities and their documentation. This essentially is a reflection of the corporate governance problem associated mainly with problem banks. The quality of disclosure has been seriously undermined by this lack of transparency to the extent that off-site analysis could not provide reliable diagnosis of emerging problem thus necessitating more frequent on-site examination especially for problem banks. This clearly, is a costly alternative for the supervisor and is avoidable if steps can be taken to make banks improve on the integrity of the mandatory returns they render to supervisors. The resolution of this problem is obviously crucial to the efficiency and effectiveness of the timeliness. Inadequate and malfunctioning infrastructure is the major problem inhibiting timely rendition of required supervisory information. It should stressed that this problem is at both the data supply and receiving ends and has to do with the general deficiency of the public telecommunication infrastructure and the late/slow adoption of advanced information technology by the banking industry.

However, the CBN and the NDIC a few years ago commenced a collaborative development of software called Banking Analysis System (BAS) for timely rendition, processing and basic analysis of prudential information from the banks. It is presently being enhanced to provide real time online data and is also being web-enabled to allow remote access to and from the banks. This it is hoped would improve both timeliness and integrity of bank returns. In the same vein, the CBN developed a Credit Risk Management System (CRMS) designed to provide accurate and reliable credit information on bank borrowers from a central database. The CRMS went live in 1998 and has continued to assist in reducing the incidence of credit extension to dubious borrowers or those already have abandoned non-performing loans with some banks. These two developments have greatly enhanced the supervisors effectiveness and sustained enhanced of software would continue to shape the future bank supervision.

2.12 Empirical Literature

Credit risk is a serious threat to the performance of banks; therefore various researchers have examined the impact of credit risk on banks in varying dimension.

Kargi (2013) evaluated the impact of credit risk on the profitability of Nigerian banks. Financial ratios are measures of bank performance and credit risk were collected from the annual reports and accounts of sampled banks from 2004-2008 and analyzed using correlation and regression techniques. The findings revealed that credit risk management has a significant impact on the profitability of Nigerian banks. It concluded that banks' profitability is inversely influenced by the levels of loan and advances, non-performing loans and deposits thereby exposing them to greater risk of illiquidity and distress. Epure and Lafuente (2002) examined banks performance improvements during 1998-2007. The results showed that performance improvement regulatory changes and the risk explains differences in banks and non-performing

loans negatively affect efficiency and return on assets while the capital adequacy ratio has a positive impact on the net interest margin.

Kithinji, (2010) assessed the effect of credit risk management on the profitability of commercial banks in Kenya. Data on the amount of credit level of non-performing loans and profits were collected for the period 2004 to 2008. The findings revealed that the bulk of the profits of commercial banks are not influenced by the amount of credit and non-performing loans therefore suggesting that other variables other than credit and non-performing loans impact on profits. Chen and Pan (2012) examined the credit risk efficiency of 34 Taiwanese commercial banks over the period was analyzed using Data Envelopment Analysis (DEA). The credit risk parameters were credit risk technical efficiency (CR-TE), credit risk allocative efficiency (CR-AE) and credit risk cost efficiency (CR-CR). The results indicated that only one bank is efficient in all types of efficiencies over the evaluated periods. Overall, the DEA result show relatively low average efficiency levels in CR-TE, CR-AR and CR-CE in 2008.

Felix and Claudine (2008) investigated the relationship between bank performance and credit risk management. It could be inferred from their findings that return on equity (ROE) and return on assets (ROA) both measuring profitability were inversely related to the ratio of non-performing loan to total loan of financial institutions thereby leading to a decline in profitability. Ahmed and Ariff (2007) examined the key determinants of credit risk of commercial banks on emerging economy banking systems compared with the developed economies. The study found that regulations are important for banking systems that offer multi-products and services; management quality is critical in the cases of loan-dominant banks in emerging economies. An increase in loan loss provision is also considered to be a significant determinant of

potential credit risk. The study further highlighted that credit risk in emerging economy banks is higher than that in developed economies.

Al-Khouri (2013) assessed the impact of banks' specific risk characteristics, and the overall banking environment on the performance of 43 commercial banks operating in 6 of the Gulf Cooperation Council (GOC) countries over the period 1998-2008. Using fixed effect regression analysis, results showed that credit risk, liquidity risk and capital risk are major factors that affect bank performance when profitability is measured by return on assets while the only risk that affects profitability when measured by return on equity is liquidity risk. Ben-Naceur and Omran (2008) in attempt to examined the influence of bank regulations, concentration. Financial and institutional development on commercial banks' margin and profitability in Middle East and North Africa (MENA) countries from 1989-2005 found that banks capitalization and credit risk have positive and significant impact on banks' net interest margin, cost efficiency and profitability.

Ahmed, Takeda and Shawn (1998) in their study found that loss provision has a significant positive influence on non-performing loans. Therefore, an increase in loan loss provision indicates an increase in credit risk and deterioration in the quality of loans consequently affecting bank performance adversely.

2.13 Theoretical Framework

2.13.1 Loan Pricing Theory

Banks cannot always set high risk interest rate, e.g trying to earn maximum interest income. Banks should consider the problems of adverse selection and moral hazard since it is difficult to forecast the borrower type at the start of the banking relationship

(Coyle, 2000). If banks set interest rates too high, they may induce adverse selection problems because of high-risk borrower moral hazard since they are likely to take highly risky projects or investments (Drehman, 2008). From the reasoning of Coyle,, it is usual that in some cases we may find that the interest rate set by the banks is commensurate with the risk of the borrowers.

2.13.2 Firm Characteristics Theories

These theories predict that the number of borrowing relationships will be decreasing for small, high-quality, internationally opaque and constraint firms, all other things been equal. (Gieseche, 2008).

2.13.3 Theory of Multiple-Lending

It is found in literature that banks should be less inclined to share lending (loan syndication) in the presence of well developed equity markets and after a process consolidation. Both outside equity and mergers and acquisitions increase banks, lending capacities, thus reducing their need of greater diversification and monitoring through share lending. (Gieseche, 2008). This theory has a great implication for banks in Nigeria in the light of the recent 2005 consolidation exercise in the industry.

2.13.4 Credit Market Theory

A model of the neoclassical credit market postulates that the terms of credits clear the market. If collateral and other restrictions (covenants) remain constant, the interest rate is the only price mechanism. With increasing demand for credit and a given customer supply, the interest rate rises and vice versa. It is thus believed that the higher the failures risk of the borrower, the higher the interest premium (Shao. 2007).

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

Research methodology is the systematic rules and procedures upon which a research is based against which claims for knowledge and assumptions are proved in favour or against prior assumptions to arrive at a decision.

This chapter basically focuses on the procedures adopted for data collection and analysis of the study. It also explains the instrument used. However, the basic objective of the methodology employed in this study is to answer the research questions stated and hypothesis postulated. The methodology covers the research design, definition of the population and samples, method of data collection and techniques of data analysis.

3.2 Research Design

Research design can be described as the programme that guides researchers in the process of collecting, analyzing and interpreting data. Research design defines the domain of generalization, indicating whether the obtained research interpretation can be generalized to a larger population or to different situations. The questions of what to study, what to observe and how to collect data are treated by research design. Research design has four components which includes; comparison, manipulation, control and generalization.

The type of research design adopted in this study is survey design. The survey approach is used because it involves collecting data in order to answer research questions as well as to test hypothesis related to the study.

3.3 Source of Data Collection

The study employs both primary and secondary data to achieve its objectives. The secondary data is derived from library documents, publications on internet, and relevant materials to be research. The primary data will be obtained through questionnaires and interviews. The study incorporates both source of data to enhance a balance between the research observation and available literature on the matter under consideration. This is always believed to promote objectively. The plan, structure and strategy of investigation are conceived so as to obtain answers to research problems. It ensures that the required data are collected and they are accurate. However, the primary data used in this study is obtained from First Bank Plc in Plateau State.

3.4 Population of the Study

The population of this study comprise of the staff of First Bank Plc, Plateau State. The population size comprised of Four Hundred (400) staff First Bank PLC, Plateau State. The population size is gotten from all branches of First Bank PLC in First Bank Plc

3.5 Sample and Sampling Procedure

The sample size (200) was taken from (400) staff of First Bank PLC in Plateau State. The sample size was calculated using 95% confidence interval.

$$= \frac{N}{1 + N(e)^2}$$

Where: N = population

n = Sample size

$$e = (0.05)^2$$

$$= \frac{N}{n}$$

$$1 + [400 (0.0025)^2]$$

Sample size = 200

Sampling techniques is a process used in statistical analysis in which a predetermined number of observations will be taken from a larger population. The methodology used to sample from a larger population will depend on the type of analysis being performed, but will include simple random sampling, systematic sampling and observational sampling. The simple random sample was used in this study. A sample of 200 out of 400 staff working in First Bank Plc, Plateau State was selected for investigation.

3.6 Method of Data Collection

The gathering of relevant data, using appropriate instrument is the bedrock of any research. In this study two methods were employed on gathering the requisite data questionnaire and personal interview.

Questionnaire

The questionnaire serves as a major tool for the collection of data for the study. It is divided into two sections. Section A which provided Bio-data about the respondents and Section B provided information which was used in the analysis and test of hypothesis formulated for the study. The questionnaire of the study would be distributed to staff of First Bank PLC, Plateau State and later collected for analysis.

Interview

This method was adopted in order to increase the depth of the study as well as obtain sensitive and salient information about issues under consideration which could not be obtained via the questionnaire. In short the interview provided an opportunity for

meeting with some of the respondents and discussion helped supply other pertinent information which greatly assisted in the findings made in the industry.

3.7 Method of Data Analysis

The data collected in this study was analyzed statistically by the use of frequency tables and percentage and Chi Square method.

$$X^2 = \frac{\sum (Fo - Fe)^2}{Fe}$$

Where: X^2 = Chi Square

Fe = Frequency Expected

\sum = Summation

CHAPTER FOUR

ANALYSIS OF DATA PRESENTATION OF RESULTS

4.1 Introduction

This chapter is concerned with the presentation and analysis of data collected for this research. In addition, the hypothesis formulated for this study are analyzed and tested. Also data collected from the questions are presented and analyzed. The results are presented and analyzed. The questions are calculated and their percentage defined. Therefore, the method of data analysis of this research is a quantitative method.

In questionnaire analysis, attempt is usually made in discovering and establishing of the existing relationship between the different variables involved in the analysis. To this extent, this chapter appraises “the efficiency and effectiveness of credit risk management in commercial banks in Nigeria, a case study of First Bank PLC” this is done through the use of Chi Square Analysis. The computational device is the statistical package for the social sciences software programme.

4.2 Data Presentation

This section presents the analysis of responses collected from two hundred respondents (200)

Table 4.2.1: Organization of the Respondents

	Frequency	Percent
Fidelity Bank PLC	200	100

Source: Fidelity Survey, 2020

The above analysis shows that 100 percent of the respondents are from First Bank Plc.

Table 4.2.2: Department of the Respondent

	Frequency	Percent
Operations	40	20
Marketing	60	30
IT	48	24
Fund Transfer	28	14
Administration	24	12
Total	200	100

Source: Field Survey, 2020

The table above shows that, 20 percent of the respondents are in Operations department, 30 percent of the respondents are marketing department, 24 percent of the respondents are in Information Technology department, 14 percent of the respondents are in Fund Transfer department while 12 percent of the respondents are in Administration department.

Table 4.2.3: Sex of the Respondent

	Frequency	Percent
Male	132	66
Female	68	34
Total	200	100

Source: Field Survey, 2020

The above analysis shows that 100 percent of the respondents are from First Bank Plc.

Table 4.2.4: Age of the respondents

	Frequency	Percent
20 – 35 years	104	52
36 – 50 years	84	42
50 – 65 years	12	6
Total	200	100

Source: Field Survey, 2020

From the table above, 52 percent of the respondents are in the age bracket 20 – 35 years, 42 percent of the respondents are in the age range 36 -50 years while 6 percent of the respondent are between the ages 50 – 65 years.

Table 4.2.5: Educational Qualification of the Respondents

	Frequency	Percent
OND/NCE	24	12
HND/B.Sc	112	56
M. Sc /PG	64	32
Total	200	100

Source: Field Survey, 2020

Table 4.2.6: Marital Status of the Respondents

	Frequency	Percent
Single	144	72
Married	56	28
Total	200	100

Source: Field Survey, 2020

From the above analysis, 72 percent of the respondents are single while 28 percent of the respondents are married.

Table 4.2.7: Occupation of the Respondents

	Frequency	Percent
IT	20	10
Officer	60	30
Accountant	32	16
Cashier	48	24
Manager	8	4
General Manager	12	6
Assistant Manager	20	10
Total	200	100

Source: Field Survey, 2020

From the above analysis, 10 percent of the respondents are IT officers, 30 percent of the respondents are Bankers, 16 percent of the respondents are Cashiers 24 percent of the respondents are Managers, 4 percent of the respondents are Deputy Managers while 10 percent of the respondents are Assistant Managers.

Table 4.2.8: Working Experience in the Organization.

	Frequency	Percent
2- 3 years	44	22
3 – 5 years	84	42
6 – 10 years	60	30
10 years and Above	12	6
	200	100

Source: Field Survey, 2020

From the above analysis, 22 percent of the respondent said to have been working in the organization between 2 and 3 years, 42 percent of the respondent said to have been working in the organization between 3 and 5 years, 30 percent of the respondent said to have been working in the organization between 6 and 10 years while 6 percent of the respondent said to have been working in the organization over 10 years.

4.3 Data Analysis

Table 4.3.1 The state of Commercial Banking in Nigeria

	Frequency	Percent
Good	28	14
Satisfactory	112	56
Fair	40	20
Poor	20	10
Total	200	100

Source: Field Survey, 2020

From the above table, 14 percent of the respondents said the state of commercial banking in Nigeria is good, 56 percent of the respondents said the state of commercial banking in Nigeria is satisfactory, 20 percent of the respondents said the state of commercial banking in Nigeria is fair while 10 percent of the respondents said the state of commercial banking in Nigeria is poor.

Table 4.3.2: Performance of credit risk management in commercial banking in Nigeria

	Frequency	Percent
Good	108	54
Satisfactory	68	32
Fair	28	14
Total	200	100

Source: Field Survey, 2020

The above analysis shows that 54 percent of the respondents said the performance of credit risk management in commercial banking in Nigeria is good, 32 percent of the respondents said the performance of credit risk management in commercial banking in Nigeria is satisfactory while 14 percent of the respondents said the performance of credit risk management in commercial banking in Nigeria is fair.

Table 3.3.3: Efficient of Credit Risk Management in First Bank Plc

	Frequency	Percent
Inefficient	64	32
Efficient	136	68
Total	200	100

Source: Field Survey, 2020

From the table above, 32 percent of the respondents said credit risk management in First Bank Plc is inefficient while 68 percent of the respondents said credit risk management in First Bank Plc is efficient.

Table 4.3.4 Effective of the Credit Risk Management on First Bank Plc Banking Operations

	Frequency	Percent
Effective	184	92
Ineffective	16	8
Total	200	100

Source: Field Survey, 2020

From the above table, 92 percent of the respondents said credit risk management on First Bank Plc Banking Operation is effective while 8 percent of the respondents said credit risk management on First Bank Plc Banking Operation is ineffective.

Table 4.3.5: Experiences of the Banking Regulations and Supervision in the past

	Frequency	Percent
Effective	40	20
Ineffective	160	80
Total	200	100

Source: Field Survey, 2020

From the above table, 20 percent of the respondents said the banking regulation and supervision in the past was effective while 80 percent of the respondents said the banking regulation and supervision in the past was ineffective.

Table 4.3.6: Problems confronting credit risk management in Commercial Banks

	Frequency	Percent
Mismanagement of Fund	32	16
Inefficiency	28	14
Fraud	80	40
Bank Distress	28	14
Limited Coverage	32	16
Total	200	100

Source: Field Survey, 2020

The table above shows that 16 percent of the respondents said the problems confronting credit risk management in commercial banks is mismanagement of funds, 14 percent of the respondents said the problems confronting credit risk management in commercial banks is inefficiency, 40 percent of the respondents said the problems confronting credit risk management in commercial banks is fraud, 14 percent of the respondents said the problems confronting credit risk management in commercial banks is bank distress while 16 percent of the respondents said the problems confronting credit risk management in commercial banks is limited coverage.

Table 4.3.7: Risk management procedures are relevant in Commercial banks in Nigeria.

	Frequency	Percent
Yes	162	81
No	38	19
Total	200	100

Source: Field Survey, 2020

From the table above, 81 percent of the respondents said risk management procedures are relevant in commercial bank in Nigeria while 19 percent of the respondents said risk management procedures are not relevant in commercial bank in Nigeria.

Table 4.3.8: Managers in Commercial banks use credit risks management procedures and guidelines

	Frequency	Percent
Yes	148	74
No	56	26
Total	200	100

Source: Field Survey, 2020

From the table above 74 percent of the respondents said Managers in commercial banks use credit risks management procedures and guidelines while 26 percent of the respondent said Managers in commercial banks do not use credit risks management procedures and guidelines.

Table 4.3.9: Commercial banks in Nigeria have written down policies and guidelines for credit risk management

	Frequency	Percent
Yes	122	61
No	78	39
Total	200	100

Source: Field Survey, 2020

From the table above, 61 percent of the respondent said Commercial banks in Nigeria have written down policies and guidelines for credit risk management while 39 percent of the respondent said Commercial banks in Nigeria do not have written down policies and guidelines for credit risk management.

Table 4.3.10: Commercial banks in Nigeria adopt global best practices in managing risks associated with outsourcing of information systems

	Frequency	Percent
Yes	156	78
No	44	22
Total	200	100

Source: Field Survey, 2020

From the table above, 78 percent of the respondent said Commercial banks in Nigeria adopt global best practices in managing risks associated with outsourcing of information systems while 22 percent of the respondent said Commercial banks in Nigeria do not adopt global best practices in managing risks associated with outsourcing of information systems.

Table 4.3.11: There is a significant relationship between credit risk management and banking operations

	Frequency	Percent
Yes	144	72
No	56	28
Total	200	100

Source: Field Survey, 2020

The above analysis shows that 72 percent of the respondents said there is a significant relationship between credit risk management and banking operations while 28 percent of the respondents said there is no significant relationship between credit risk management and banking operations.

Table 4.3.12: Credit risk management contributes positively to banking industry's profitability in Nigeria

	Frequency	Percent
Yes	138	69
No	62	31
Total	200	100

Source: Field Survey, 2020

The above analysis shows that 69 percent of the respondents said credit risk management contributes positively to banking industry's profitability in Nigeria while 31 percent of the respondents said credit risk management does contributes positively to banking industry's profitability in Nigeria.

4.4 Test of Hypothesis

4.4.1 Research Questions/Hypothesis 1

Table 4.3.11: There is a significant relationship between credit risk management and banking operations

	Male	Female	
Yes	120	24	144
No	12	44	56
Total	132	68	200

Observed	Expected	O - E	(O - E) ²	(O - E) ² /E
120	95.04	24.96	623.00	6.56
24	48.96	- 24.96	623.00	12.72
12	36.96	- 24.96	623.00	16.86
44	19.04	- 24.96	623.00	32.72
				68.86

$$X^2 = 68.86$$

The hypothesis formulated is tested by means of the Chi-square.

The Chi-square is 68.86, which shows that the Chi-square calculated is less than the Chi-square tabulated (3.84).

As a decision rule, if the computed value of the Chi-square is less than the critical value of X^2 at 5% level of significance, the null hypothesis (H_0) is accepted, while the alternative hypothesis (H_i) is rejected. The reverse is however the case if the computed value of X^2 is greater than the critical value at the chosen level of significance.

Conclusion: since the computed value of Chi-square (68.86) is greater than the critical value (3.84), therefore the alternative hypothesis (H_i) “there is a significant relationship between credit risk management and banking operations” is accepted.

4.4.2 Research Questions/Hypothesis 2

Table 4.3.12: Credit risk management contributes positively to banking industry’s profitability in Nigeria.

	Male	Female	
Yes	120	36	138
No	30	32	62
Total	132	68	200

Observed	Expected	(O – E)	(O – E) ²	(O – E) ² /E
102	91.08	10.92	119.25	1.31
36	46.92	- 10.92	119.25	2.54
30	40.92	- 10.92	119.25	2.91
32	21.08	10.92	119.25	5.66
				12.42

$$X^2 = 12.42$$

The hypothesis is formulated is tested by means of the Chi-square.

The Chi-square is 12.42, which shows the Chi-square is less than the Chi-square tabulated (3.84).

As a decision rule, if the computed value of the Chi-square is less than the critical value of X^2 at 5% level of significance, the null hypothesis (H_0) is accepted, while the Alternative Hypothesis (H_1) is rejected. The reverse is however the case if the computed value of X^2 is greater than the critical value at the chosen level of significance.

Conclusion: since the computed value of Chi-square (12.42) is greater than the critical value (3.84), therefore the Alternative Hypothesis (H_1) “Credit Risk Management contributes positively to banking industry’ profitability in Nigeria” is accepted.

4.5 Discussion of the Findings

Commercial banks are in the risk business. In the process of providing financial services, they assume various kinds of financial risks. Over the last decade our understanding of the place of Commercial banks within the financial sector has improved substantially.

The risk contained in the bank’s principal activities. i.e. those involving its own balance sheet and its basic business of lending and borrowing are not all borne by the bank itself. In many instances the institution will eliminate or mitigate the financial risk associated with transaction by proper business practices; it will shift the risk to other parties through a combination of pricing and product design.

Banks play their significant role in any economic system. They are financial intermediaries involve in transfer of funds within and outside the country. Banking sector is getting competitive every day. Quality, speed, efficiency, innovation are the

main points on which quality programs are designed. All banks are engaged in same basic banking activities but it is the way of delivery of service that distinguishes one bank from the other. All banks worldwide are considering quality in the strategic management.

From the above analysis, 69 percent of the respondents said credit risk management contributes positively to banking industry's profitability in Nigeria while 31 percent of the respondents said credit risk management does not contribute positively to banking industry's profitability in Nigeria.

Also 72 percent of the respondents said there is a significant relationship between credit risk management and banking operations while 28 percent of the respondents said there is no significant relationship between credit risk management and banking operations

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary

This study attempted to appraise the efficiency and effectiveness of credit risk management in commercial banks in Nigeria, a case study of Fidelity Bank Plc.

The banking industry has long viewed the problems of risk management as the need to control four of the above risks which make up most, if not all their risk exposure, viz., credit, interest rate, foreign exchange and liquidity risk. While they recognize counterparty and legal risks, they view them as less central to their concerns. Where counterparty risk is significant, it is evaluated using standard credit risk procedures, and often within the credit department itself. Likewise, most bankers would view legal risk as arising from their credit decisions or, more likely proper process not employed in financial contracting.

The Banking industry recognizes that an institution need not engage in business in a manner that unnecessarily imposes risk upon it; nor should it absorb risk that can be efficiently transferred to other participants. Rather it should only manage risks at the firm level that are more efficiently managed than by the market itself or by their owners in their own portfolios.

The analysis result found out 74 percent of the respondents said managers in commercial banks use credit risks management procedures and guidelines while 26 percent of the respondents said managers in commercial banks do not use credit risks management procedures and guidelines. Also 81 percent of the respondents said risk management procedures are relevant in commercial bank in Nigeria while 19 percent

of the respondents said risk management procedures are not relevant in commercial bank in Nigeria.

5.2 Conclusion

This exploratory empirical study investigating risk management practices in Commercial banks in Nigeria has led to several important conclusions. While some of these have confirmed my initial understanding, others has been contrary to ordinary intuition. The survey showed that in spite of the lack of regulations and infrastructures in the country, the scope of outsourcing is broad and there exists ample room for commercial banks to adopt well-defined and structured risk management guidelines, policies and procedures. Although the sample size is representative of the population of banks in Nigeria, and the results provide valuable insights into the risk management practices in the outsourcing process, the need for further work in this area is strongly recommended, further research effort should expand the body of literature, but also critically examine, document and recommend the roles of managers in banks and regulatory and supervisory bodies in enforcing the adoption and adaptation of global best practices.

The results showed that although the level of outsourcing is high in all banks, there were both similarities and differences in outsourcing processes across banks. There are differences in the information systems functions they outsource. For example, the banking software is outsourced in all banks. Software development and technical support are outsourced in bank A and bank B only, and selectively, while bank D only outsourced telecommunications platform. The percentage of the banks engaged in selectively outsourcing is 100%, but far less get involved in total outsourcing. The principal cause of these differences can be attributed to the perceived risks and

benefits of various modes of outsourcing and the rate of the country's adoption to technology.

Disaster recovery is considered to be important as well, and the study showed that though there seems to be disaster recovery plans, these plans do not cover all the foreseeable problems of disaster issues.

This study pioneered new interesting empirical evidence on the risk management practices in the outsourcing of information systems in commercial banks in Nigeria. Bank executives can also use this evidence as an input to their own decision making to improve their Information Systems operations. Regulatory bodies like the Central Bank of Nigeria and the Nigeria Deposit Insurance Company can use this evidence as an input in developing standard guidelines in the management of risks that could result from outsourcing information systems. Vendors can use it to select and promote their information system services and Research as a framework for further study in developing countries.

5.3 Recommendations

The policy recommendations of the study are stated below:

Banks in Nigeria should enhance their capacity in credit analysis and loan administration while regulatory authority should pay more attention to banks' compliance to relevant provisions of the Bank and other Financial Institutions Act (1999) and prudent guidelines.

Commercial banks in Nigeria should adopt best practices in managing the risk associated with information system.

Banks in Nigeria should have better lending skills and able to engage in arms-lending and resist government pressures, and potentially impose fewer demands on government for bailouts than the intermediaries they replaced.

The banking reform should rely mostly on interest rate operating procedures for macroeconomic management with the sole objective of moving towards the 'law of one market' in both the domestic and international money markets.

The overriding objectives would be to minimize interest and exchange rates risks that can adversely affect the rate of return on domestic and international financial investments in the country.

The right incentives would be created for the inflow of foreign and domestic investment into the country. This requires the urgent need to fine-tune the banking sector reforms through the deliberate adoption of policies that would ensure convergences of domestic and international rates of return on financial markets investment.

On the domestic scene, there is the need to narrow the gap in interest rates structures of alternative financial markets investment portfolios. In particular, there is the critical need to determine the appropriate benchmark for interest rates policies.

Although a market based supply side policies was expected to attain this, the monetary authority would need to be less concern with the perceived adverse trade off implicit in their current approach.

The reforms in banking sector should attract more foreign investment inflows especially in the area of portfolio investment.

Prudential regulation and supervision should be improved in the banking sector.

Central Bank of Nigeria should engage monetary policy to coordinate bank credit for efficient banking performance in Nigeria.

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