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Corporate Governance & Operational Risk Management in Banking Industry (Research Paper)

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The Role of Corporate Governance on Effectiveness of Operational Risk Management

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ABSTRACT

Banking and financial industry has been serving as a back bone in an economy. At the same time, this industry is highly perishable and sensitive of many risks including credit, market, operational and strategic risks. For mitigation of credit and market risks there are number of testified models and quantitative techniques which gives us more or less accurate outcomes. However, for operational and strategic risks, available techniques and models have not remained that much effective. Here It is pertinent to mention that the strategic risk in banking industry may not be common to all because it is being viewed from other way round and named as “corporate governance”.

The purpose of studies is to gauge the non-linear but direct relationship between corporate governance and operational risk management. It is important to understand that the operational risk is about set of operational processes and internal environment within the bank. Whereas the corporate governance is to regulate and maintain the business environment by implementing the policies and regulations.

The role of corporate governance has remained a prime concern in banking industry especially from early 2000s. A part of top line and bottom line of business performance, the effectiveness of corporate governance can also be measured from 1) risk management, 2) audit and compliances and 3) regulatory requirements under the jurisdiction of local/applicable regulatory laws.

It is important to understand here that the sensitivity of problem has been identified by the different scholars and regulatory authorities including European Central Bank (ECB), European Banking Authority (EBA), Bank of International Settlements (BIS), World Bank (WB) and Organization of Economic Co-operation and Development (OECD) etc. These organizations have also been providing number of obligatory/voluntarily directives for ensuring results, but it is an on-going process in lieu of changing environment, technologies and other global issues.

KEYWORDS

Economy, prudential regulations, directives, models

INDEX

LIST OF ABBREVIATIONS AND ACRONYMS

BIS	Bank of International Settlements
BoP	Bank of Portugal
BoE	Bank of England
EBA	European Banking Authority
ECB	European Central Bank
EIB	European Investment Bank
OECD	Organisation for Economic Co-operation and Development
CG	Corporate Governance
ORM	Operational Risk Management
SBP	State Bank of Pakistan
BoD	Board of Directors
CEO	Chief Executive Officers

1. INTRODUCTION

The role of effective corporate governance and independent operational risk in a bank are inter-dependent variables. Several financial events during last decade, whether desired or undesired, have proved that the banking is not all about the financial management with mitigation of financial risks only. The internal space to breath also play a vital role for its survival of a bank in long run.

A universal fact is that the senior management or board of a bank always want to have numbers and results at the end of each year. This desire made them aggressive and compromising in many decisions for short term benefits in shape of high stock price, goodwill and market standing (Liang, Lu, Tsai, & Shih, 2016)

These short terms benefits evaporate by the time, but negatives of these benefits start depositing into the system silently which turn into a surprise at organizational level and wide-spread crises at economy level. The most recent examples of financial crises are in year 1997 and year 2008.

The banking world has been growing in a very complexed manner wherein risks factors are also increasing with different names and in different shapes. In the early ages, it was assumed that there was only one risk for the banks and that was default risk or credit risk for its assets side. However, by passing through different ages of economy, it has become necessary to see the banking models and associated risks with the magnifying glass (Hopt, 2013).

The role of effective corporate governance is a critical success factor in the life of any bank. It is evident from the findings of financial crises of year 2008. The studies have proved that the effectiveness of corporate governance has been more compromised in banking sector as compare to other sectors (Adams, 2009). In the pre-crises era, banks were assuming that effective corporate governance is all about financial performance in a specific period and as a result they paid a huge cost for this belief (Mülbert, 2012).

It also been observed that BIS have taken this issue very seriously and given a set of guidelines for the banks to follow (Committee, 2015). But this is not the end of our findings, it is an on-going process therefore, we must keep looking to the environment and challenges bubbling around sometimes, temporarily and time-barred and sometimes these challenges are the early warning signals.

It may be noted here that the immediate exposed risks to a bank are from both external and internal environments. However, we have selected effectiveness of operational risk as it belongs to the internal environment and procedures of the bank which is maintained and created by the corporate governance. We want to see it in a closed environment which has not been considered earlier by other researchers.

Internal environment or corporate governance is considered as sensitive and crucial for any institute and must deal with the external environment. It has also been observed that some of the researchers have named dealing with external corporate governance as “agent problem”. Here the external corporate governance is referred as external environment for any organization (Dedu & Chitan, 2013). The scope of internal environment has been described as limited in the referred studies, but emphasis and impact weightage are very high for a bank.

In a bank, the role of corporate governance may be influenced by many stake holders within organization and from external environment. “Parties interested in the good functioning of an entity, namely its shareholders, its management, its stakeholders, undertake and take steps in the field of risk management in order to ensure adaptability to the business environment and business continuity, their failure leading to manifestation of the governance risk”(Jiang, Feng, & Zhang, 2012).

It is an established fact that corporate governance is a grey area wherein you may find may invisible forces working on its style. But researchers remained very focused over the period to understand these factors one by one. The role of corporative governance in banks has already been recognized by the global regulators like Basel, OCED & ECB/EIB and regional controlling authorities (Kong, Club, & Kong, 2001).

On the other hand, operational risk is also about internal environment and remains as important as corporate governance. In any bank, operational risk management is not to comply regulatory requirements on papers but implementation in true latter and spirit under the supervision of management. It improves Banks’s immunity for system failures, in adequate controls and procedures, unauthorised activities or any external event. Therefore, the allocation of capital for operational risk has become significant globally and being complied by the banks. Although there are some countries still working on it to make it more effective according to their markets and economies including Asia and Pacific region (Xie, Wu, & Hu, 2011).

Operational risk is one of important issues in any commercial bank operation, which means unexpected loss resulted from inaccurate operation of staff, failure of system, inadequate control and procedure, unauthorized activity or external event. In some business, operational risk is more important than credit risk and market risk. Many banks in the world don’t allocate any capital for operational risk, this also happens in China commercial banks. The reason is not that operational risk is not important, but that we don’t know how to measure and manage operational risk.

We study the effect of bank governance on risk-taking in commercial lending. Banks with more effective boards are less likely to lend to riskier borrowers. This effect is restricted to periods of distress in the banking industry and is stronger at banks with board-level credit committees. Banks with more effective boards are less likely to lend to riskier borrowers right after the Russian default, which exogenously imposed distress conditions on U.S. banks. Thus, value-maximizing banks appear to ration credit to riskier borrowers precisely when such firms might be credit-constrained, suggesting that bank governance regulations may have potential unintended consequences.

1.1. RESEARCH OBJECTIVES / GOALS

The prime objective of study is to establish a direct but non-linear relationship between two independent variables i.e. Corporate Governance and Operational Risk of a bank. The importance of these variables has been increased by many times over the periods. The both functions needs to be performed independently in their own jurisdiction but connected in a unique way which trigger down the style of corporate governance in performance of operational risk management in a bank.

The scope of corporate governance is not as similar as in other industries (Hopt, 2013). It has a wider perspective which starts from the basic stakeholders and goes beyond debt-servicing, credit management, private and public loaning, policies and procedures and last but not the least working and operational environment. Therefore, independent operational risk management is considered as reflection of effective corporate governance (Barakat, 2011). It also gives sustainability to the life of a bank.

The Basel committee of Bank of International Settlements imposes more emphasis towards operational risk management in financial institutions. It also has the perspective of having an effective control on internal environment to make the bank more sustainable in any situation (Dorogovs, Solovjova, & Romanovs, 2013)

Nowadays, financial institutions highly recognize a great influence of effective risk management on profit abilities. Therefore, risk management became an important part of the financial instrument. According to the latest researches, there still remain problems related to the management of various types of risks. For instance, the Basel Committee of the Bank of International Settlements imposes financial institutions for more intensive devoting their attention to operational risk management problems. Due to the increased intensity of performed financial operations, financial institutions became very vulnerable to operational risks. In many cases, the high level of operational risks is conditioned by IT system failures.

The established fact is that the corporate governance plays a leading role in effectiveness of operational risk management in a bank (Zekos, 2014). Hence, it is the main objective to determine the effectiveness of Operational Risk Management in a bank reflects its corporate governance style in a closed business environment of a bank.

To achieve the main goal of the research paper, the following are the specific objectives:

1- To explore the possibility of establishing a direct relationship between effective corporate governance and independent operational risk management in a financial institution. The amount of impact from corporate governance on its operational risk management function varies from situation to situation depending on the demographics & external environment.
2- Analyse the impact of different governance models as referred or directed by Basel, ECB and EBA on the quality of operational risk management in banking industry.

The objectives are very understandable and relevant to the current global economic challenges and regulatory authorities are constantly developing solutions and way-outs to manage it (Corporate & Factbook, 2017).

2. LITERATURE REVIEW & STUDY RELEVANCE:

"Corporate governance is the system of rules, practices and processes by which a company is directed and controlled"[1] and the purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company[2]. The diagram stated below is to better understand the connectivity of corporate governance to the associated risks in an organisation:

Figure 1:Corporate Governance & Risks
Source: http://octagon-advisors.biz/risk-management.htm

[1] Definition by www.investopedia.com
[2] https://www.icaew.com/technical/corporate-governance/uk-corporate-governance/does-corporate-governance-matter

The role of effective corporate governance is a critical success factor in the life of any bank. It is evident from the findings of financial crises of year 2008. In this regard, many studies have proved that the effectiveness of corporate governance has been more compromised in banking sector as compare to other sectors (Adams, 2009). In the pre-crises era, banks were assuming that effective corporate governance is all about financial performance in a specific period and as a result they paid a huge cost for this belief (Mülbert, 2012). The issue starts with the governance styles and their approaches towards procedures and internal controls of a bank. Although the prime economic objective of any bank is to make profits and economic returns but at the same time, focusing on the results compromise the quality of business continuity. Therefore, the non-quantifiable factor i.e. corporate governance is having a hug impact on the life cycle of any bank.

To ensure the effective governance, there were guidelines for internal audit committees and board of directors, but the guidelines were not dynamic enough to address the role of board. These guidelines were drafted without understanding the real power of a director in a bank or corporate. The financial crises of year 2008 triggered the legislators to re-do the work and the concept of 2-Tier board was evolved in Europe and UK, in order to improve the internal control system and risk management environment(der Elst & Elst, 2013).

BIS have taken this issue very seriously and given a set of latest guidelines for the banks to follow (Committee, 2015). But this is not the end of our findings, it is an on-going process therefore, we must keep looking to the environment and challenges bubbling around sometimes, temporarily and time-barred and sometimes these challenges are the early warning signals.
Since the governance is the strategy drafted by the top management of the bank therefore, characteristics of board member are very important. In this regard, EIB, ECB and BIS recommendations for an existence of a clear policy on the appointment, retention and succession of directors. To have a positive impact on performance of bank requires more financial experts in management but subject to the behaviour and approach to influence the operations and bank’s procedures (Dedu & Chitan, 2013).

When we talk about corporate governance in credit institutions including banks the followings have strong relevance:

1. governance and control structures of credit institutions, as well as their activity, paying a special attention to the Administration Board
2. the role of monitoring authorities and interest conflicts
3. the treatment of minority shareholders and the situation of interest’s owners
4. risks governance and adjustment of the internal control function to the risk profile of the institution;

5. internal audit
6. ethics (Manea, 2015)

Unfortunately, the global banking system still needs to understand the fragility of economic situation and to work on fill-in the gaps. The scope of corporate governance may be expanded but to remain focused and effective, the above refer pillars may considered as key indicators to understand the effectiveness of corporate governance.

The financial crises during the last decade, have strengthen the importance regulated and reliable banking system. Subsequently, the focus has been shifted from quantitative aspects to qualitative aspects. It is to make the system to work under different economics circumstances and to ensure that the system does not require any infusions of external resources to maintain its operations (Onyiriuba & Onyiriuba, 2016). These aspects need to be monitored and complied under the management of a bank (Dorogovs et al., 2013).

In wake of the recent crises, the awareness is increasing for corporate governance framework. The evolving problems of corporate governance including the board composition, management approach and independence of a director to analyse the ground facts affecting its financial stability.

A series of measure have been taken globally besides BIS, ECB and OCED. For example, A unanimous corrective measure for CG is UK Corporate Governance Code wherein the board should conduct a review in the company to see the effectiveness of risk management, internal procedures and operation controls for disclosure of its shareholders. This step reveals the importance of CG in corporate world (Council, 2018)[3].

The term operational risk management (ORM) is defined as a continual cyclic process which includes risk management, risk decision making, and implementation of risk controls, which results in acceptance, mitigation, or avoidance of risk. ORM is the oversight of operational risk, including the risk of loss resulting from inadequate or failed internal processes and systems; human factors; external events. Unlike other type of risks (market risk, credit risk, etc.) operational risk had rarely been considered strategically significant by senior management[4].

In banking industry, ORM arises from execution of business operations. The concept is very wide including people, systems and internal procedures. ORM in a bank considered as integral part of decision making process for the management to overcome the possibilities of business failures and collapses proactively (Habib, Masood, Hassan, Mubin, & Baig, 2015).

[3] https://www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code
[4] https://en.wikipedia.org/wiki/Operational_risk_management

According to global standardized approach, risk management process may be divided into following four steps[5]:

- Establish Context
- Risk Assessment
  1- Risk Identification
  2- Risk Analysis
  3- Risk Evaluation
- Risk Treatment
- Monitoring & Review

It is pertinent to mention that the ORM has different application of risk management because it is not to ensure the profitability. The core benefits from an effective ORM are as follows:

- Reduction in operational losses
- Lower penalties for non-compliance of regulatory requirements
- Early warning signals arouse for any unlawful activities
- Strong immunity towards avoidable economic situations

Operational risks are mainly associated with these seven categories, but the scope is expanding due to the complex banking systems and continuous changing environment.

Figure 2: Operational Risk Categories,
Source: Note[6]

[5] Source: www.iiste.org
[6] https://ac.els-cdn.com/S1877042813040093/1-s2.0-S1877042813040093-main.pdf?_tid=f1263620-56d8-44df-9fed-0f644c3455f2&acdnat=1543187020_2d5b5ceab80a1828610af49255ad165d

In many countries, banks still have difficulty in understanding interconnected factors related to operational risks. It requires extra effort to build the culture within the bank. Subsequently, it would ultimately turn the reactive behaviour and short term measures into an integrated, proactive behaviour and long-term measures for ORM (Fritz-morgenthal, Huber, & Funaro, n.d.). It is also needed to understand that the internal environment for a bank is the space wherein all economic and non-economic activities take place and leave an impact on the face of bank in external environment. Therefore, what so ever policy is being followed internally always has an impression on its standing in an economy.

As evident during the last decade, Basel III and OECD directives are mainly focusing on the ORM and code for CG. The directives are obligatory to be followed by the European countries whereas these available to the rest of world on voluntarily basis (OECD, 2017). However, the regional global regulators are also working based on these directives in their own jurisdictions, but it requires much more to understand the true spirit[7]. It also gives a clear understanding to all that external factors and environment cannot be controlled therefore, the organisations here referred as banks need to be prepared internally to deal with it.

It is understood that every internal failure or compromised procedures attracts direct losses and owing to the fact BIS is constantly working on ORM development and keep building buffer zones in the regulatory capital requirement. It is evident from the given diagram:

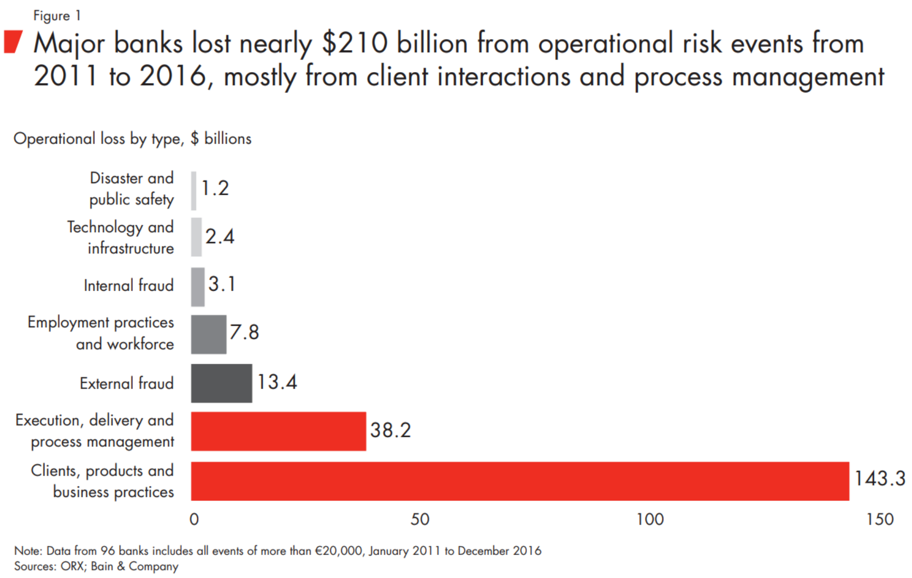
Figure 3: Regulatory Capital Requirement by BASEL III,
Source: https://www.slideshare.net/maryymao/fins3630-class-presentation-basel-iii-final

[7] http://www.cbrc.gov.cn/EngdocView.do?docID=231AD998D90B4AE585383BF38089E194

The requirement for the capital is not just to build a number, the concept behind it to make a bank's life more sustainable and shocks absorbing. At the same time, it needs to work on both sides, not limited to the capital requirement. The internal CG guidelines (OECD, 2017) and ORM directives (Committee, 2015) needs to be implemented in true spirit. This is the problem where banks have limited its regulatory compliance towards capital whereas, internal systems need to be re-visited to ensure the quality of ORM.

There are many case studies which have been reviewed and referred by the researchers over the period. After Lehman's bankruptcy, there was another company named Worldcom wherein the operational risk management failure was the outcome of management's self-interest and immense influence on the procedures, compromising internal controls and daily business operations (Thornburgh, 2004). Since the time, the case has been referred as crises of corporate governance.
We advocate for a strategic approach towards operational risk management, defining risk appetite, tolerance and significant monitoring of procedures.

There are some reported numbers to see the instant impact of influenced or compromised ORM[8]:



The researchers are keep trying to find a concrete reason for the financial crises of year 2008 but so far, the findings are in grey area and it is difficult to bring black and white out of situation. In addition, at the same time, they have at least concluded that the impact of failure of non-quantified facts is much higher than others and the statement is supported by the number of reported instances in financial sector[9].

[8] https://www.bain.com/insights/how-banks-can-manage-operational-risk/
[9] https://www.economist.com/schools-brief/2013/09/07/crash-course

Over the period after passing through many financial crisis, the importance of closer attentions towards compliance of regulations by banks has been increased. As a result, compliance monitoring units have been evolved in banking industry within ORM. These departments within banks monitor the risk of non-compliance of regulations by using different monitoring tools. The scope of monitoring area is increasing and developing an approach of integrated operational and compliance risk management (Losiewicz-Dniestrzanska, 2015).

The development of banking system over the decades has shown that regulatory requirements needs to achieve the up-to-mark banking state in quantitative and qualitative outcomes. The necessity of a strong financial system is need of hour throughout the world. The trend of banking supervision is not only changing its role but also widen its area to make it more effective and practical for the banks. The efficiency of supervisory role in banks can be viewed in the stressed economic situations. It requires to work on organizational internal structure wherein operations are performed without compromising the SOPs and internal policies. It also needs to build a productive interaction with internal and external auditors without getting influenced by the tier management to work on the gaps (Buvanendra, Sridharan, & Thiyagarajan, 2017).

The improvement in supervisory role as explained by Pjotrs & Solovjova, can be obtained by following:
Recurring Risk Assessments of internal controls to fill-in the gaps
Optimum Decision-Making Model
Qualified Staff
Corporate Governance and Operational Risk of a bank needs to be performed independently in their own jurisdiction but connected in a unique way which trigger down the style of corporate governance in performance of operational risk management in a bank. However, the conflict of interest may prevail between the parties' due to the objectivity. It has also been accepted that the management deals challenges externally and internally. At the same the time, the external challenges are always beyond control and may be mitigated however, the internal challenges may be eliminated by improving the internal control process, compliance and independent operational risk management, thus increasing emphasis on corporate governance in banking industry because it is doing business on trust and that is public saving.

The scope of corporate governance in banking industry is not as similar as in other industries (Hopt, 2013). It has a wider perspective which starts from the basic stakeholders and goes beyond debt-servicing, credit management, private and public loaning, policies and procedures and last but not the least working and operational environment. Therefore, independent operational risk management is considered as reflection of effective corporate governance (Barakat, 2011). The indicator of performance is not only the number of disclosures as a regulatory requirement under the risk management policy but the length of business life and frequency of financial disasters over the period a bank faced.

The established fact is that the corporate governance plays a leading role in effectiveness of operational risk management in a bank (Zekos, 2014).

It is the need of hour to understand that banking is no more on parameters which were used in early 1990's or 2000's. The dynamics of banking environment have been changed and keep changing around the globe. if we will review the near history, number of financial events and crises will surface on the screen with narration of different reasons which either not visible or readable to the management before the time or management just compromised to attain an absolute number. By the time researcher started to see insights of the banks, they ended up with the conclusion about an influenced governance and weak operational controls (Cabalu, 2005). ECB and EBA had also started to work on guidelines for the regional banks for a unanimous banking setup (Committee, 2015) (European Commission, 2010).

The work has become now very relevant and critical factor as the banking industry is a service industry wherein it needs to maintain the complexed financial web out of public money. External environment and other external factors may be mitigated but not in control of a bank. However, the role of corporate governance for its operational risk management is the key element (der Elst & Elst, 2013).

It has also been observed that in many situation, the worsen situation was an outcome of in-effective operational risk management because its management had compromised on internal procedures and workflow environment (Grove, Patelli, Victoravich, & Xu, 2011).

To have an effective operational risk measure, bank should have a hybrid style corporate governance
wherein business and numbers may reflect the picture of strong internal systems. It is also needed to realise that the corporate governance may change it style for a shorter period but its core parameters towards risk management should remain intact especially towards operations for policies and procedures (Berger, Imbierowicz, & Rauch, 2012).

The sensitivity and importance of corporate governance can be seen from the series of guidelines from BIS, EBA and ECB aiming to have strong insight of regional banks. Operational risk management is one of the key component in BASEL III and has a centric importance (Basel Committee on Banking Supervision, 2010).

Although the internal environment (related to corporate governance and operational risk management) does get affects and shocks from external environment but standby buffers may be created by the management. Therefore, role of management and corporate governance have a very strong impact on bank's survival in any situation (de Haan & Vlahu, 2016).

3. METHODOLOGY:

In the given context, a hybrid methodology has been used for the studies and comprises of following two tools:

- Literature Review
- Discussion with Focus Groups

Focus group discussion is one of the techniques to explore the human behaviour although it is not very common but prevails and remained very effective where the studies are directly dealing with insights and human behaviour towards acceptance and rejection for any policy or regulation (Guerrero & Xicola, 2018)

It is needed to explain here that the objective of studies is very sensitive and to uncover some of internal flaws in any bank therefore, it was important to have the real-time feedback and comments from the industry players and banks. Therefore, discussion with Focus Group has been followed-up to complete the studies.

Our selected focused groups are from ECB, EIB, South Asian Banks, MENA Banks and Portuguese Banks:

- Senior Bankers
- Economists
- Senior Risk Analysts
- Professors and Researchers

Seniors bankers are the professionals who were serving in banking industry for more than 15 years. They are mostly from the top and middle-management and engaged in policies executions and implementation.

It was fortunate to have some interaction with economist from Europe and Asia wherein these economists had close observations on global trends of changing economic situation. Our senior risk analysts are from the operational risk management departments wherein they are responsible for compliance monitoring and proactive operational risk management.

Professors and other researchers are from Portugal wherein I have been able to discuss the topic within different universities including Universidade Nova de Lisboa and Universidade de Lisboa.

In this regard, the visits were made to Pakistan, UAE, Belgium and England besides Portuguese forum. The literature review has already been extensively referred above wherein an established relationship has been observed between Corporate Governance and Operational Risk Management in banking industry.

3.1. BRUSSELS, BELGIUM

The discussion was started from the discussion forum in Brussels on 17th October 2017. There was workshop organized by EIB and EU on “The role of social financial intermediaries in deploying financial instruments under the European Social Fund in the 2014-2020 programming period”.

The key speakers were from EIB, European Parliament and other European economists etc. During the session there were specific hours for discussion. They have shown an explicit concern over the implementation of policies in banking industry. They were of the view that even the policies are made by engaging all skate holders and their feedback but at the same time, adaption of directives and policies are compromised for instant returns and short-term benefits.

They found it extremely challenging for ECB to deeply investigate the loop-holes in every banking set-up of all European countries. The powers have been delegated to make an effective strategy by creating different committees, but stances of banks failures are still surfacing.

An official from BIS has mentioned that the influence of CG on bank’s internal control cannot be eliminated thoroughly subsequently, top-up of buffer capital has been introduced to mitigate the risk of external or internal failures (ECB, 2010).

The discussion remained focused on the independent role on ORM and concluded on following points:

- Banks with “unacceptable” specific risk models are expected to take immediate action to correct the problem.
- To ensure that there is a sufficient capital buffer to absorb the risk that the backtest showed had not been adequately captured.
- The role of ORM should be dedicated and independent within the scope of regulatory requirements.
- CG must create the environment for independence of ORM.

Senior researchers from BIS have mention that the empirical data they are using for their work have shown the CG have been affecting significantly the internal controls and operations which multiplied the expected losses to manifolds. Therefore, the impact of CG on ORM is direct and substantial in a bank.

3.2. LAHORE, PAKISTAN

Another visit was made to Pakistan on 27th of April 2018 till 14th May 2018. The visit was planned to interact with the senior Pakistani bankers and policy makers. In this regard, different top-tier banks have been shortlisted and engaged including Allied Bank of Pakistan, Habib Bank of Pakistan, Askari Bank Limited, Alfalah Bank Limited, Silk Bank and National Bank of Pakistan.

The discussion sessions were arranged on three occasions to remain more informative and accurate information. It is pertinent to mention that the country Pakistan has an obligation to adapt Basel III. The obligation has been imposed by International Monetary Funds (IMF). The group was concern on adaption of Basel III directives because of difficult economic situations and digital gaps. Due to lack technology adaption, appropriate risk management & compliance issues, many of banks are considered vulnerable for bankruptcy and bearing penalties from the regulator i.e. SBP (State Bank of Pakistan)[10].

As per our focused group, it is very common in Pakistan that the banking procedures use to compromised for the self-interest of top management and down the line, staff tend to accept the influence due to insecurity of job. The referred dilemma may be supported by the recent bankruptcy of a bank in Pakistan. The facts never been disclosed by the regulator due to sensitivity but focus group has endorse the core lapses. In some situation, banking staff is Pakistani banks also need to understand the importance of operational risk management.

Bank Analysts and researchers from the regulatory bank have explicitly mentioned that the banks need to work on ORM and the internal structure. As per prevailing regulations in Pakistan, banks need to establish the compliance unit under the supervision of BoD instead of CEO.

The facts have indicated that banks where Risk Management Units (including ORM & Compliance Units) directly report to BoD instead of CEO or other corporate entities remains more sustainable in stressed economic situations. The instructions have been complied by all banks in Pakistan, but role of these units remained due to influential CG in the banks where the management has direct influence on internal controls.

As mentioned, the reporting line of ORM has already been defined by SBP to have effective CG in banks whereas scope of ORM is as follows:

- Full implementation of ORM across all business areas within bank.
- Clearly define ORM roles throughout the bank

[10] http://www.sbp.org.pk/BS/RF.asp

- Regular feedback loops in the ORM organization to ensure continuous learning, from both success and failure.
- Regular validation of holistic approaches to deal with changing environment.

3.3. DUBAI, UNITED ARAB EMIRATES

There was another visit to Dubai on 14th May 2018 to 15th May 2018, wherein a table discussion was arranged with bankers & analyst from Commercial Bank of Dubai, Standard Chartered-MENA & Bank al Mashreq. The bankers from MENA region were very much aware of ORM effectiveness and CG role.

They are strictly complying the regulatory requirements under the supervision of UAE Central Bank. Basel II has also been complied voluntarily to strengthen the banking industry, in addition, latest regulations, are drafted in accordance to the demographic of Gulf but covering the core policies and procedures issued by BIS (Bin, Al, & Emirates, 2018).

The resilient banking system of UAE is based on compliance of all regulatory requirement with zero tolerance. Subsequently, following were the highlights from UAE banking industry:

- The Central Bank of UAE is fully committed to adopt international standards.
- UAE Basel III capital framework was published in 2017.
- All banks remained well capitalised with adequate buffers above the minimum capital requirements.
- Directives for ORM are fully complied and CG or management never by-pass the procedures and SOPs (standards of practices).

3.4. LONDON, ENGLAND

I also had been able to discuss the subject matter with Britain Bankers in London. My schedule of visit started from 2nd August 2018 till 5th August 2018. I have been invited by a researcher from Manchester University. The group members were from Lloyd bank & Royal bank of Scotland. Fortunately, they were all working in ORM units in their respective organizations.

The point of discussion was to know about the difficulty in ORM effectiveness. it has also been told by the participants that the Bank of England (BoE) has already developed the guidelines and regulations in collaboration of ECB and EBA due to EU engagement. The compliance is being monitored by BoE on periodic basis and have shown zero tolerance on violation if any. the reason is not to experience the previous collapses of financial crisis in year 2008. Many local banks have done some mergers to ensure the compliance of regulatory requirement where so ever it was required.

Although 2019 is the year for Brexit, but England is fully prepared to handle its banking industry. They anticipated that there are more 20 small banks or financial institutes moving towards mergers by the end of year 2018.

Before financial crisis 2008, bankers found it difficult and irrelevant to establish a separate unit for ORM to work independently but gradually, the understanding has developed among the bankers and teething period is over in England now. They mentioned that some of mergers are voluntarily to become more sustainable within industry.

The discussion was concluded on the following points:

- Banks have demonstrated an increased awareness for effective MRM frameworks (relevant to qualitative and quantitative risks mitigation)
- Rigorous compliance of Bank's 2015 Stress Testing Approach Document[11].
- Corporate Governance is supporting independent ORM in banks (Monks, R. 2011)

3.5. LISBON, PORTUGAL

In Lisbon, I have been able to fetch an opportunity to discuss the subject of my studies with researchers from Universidade de Lisboa and Professors from Universidade Nova de Lisboa. Their research, based on a set of the major Portuguese banks, was able to conclude that banks are still minimizing the impact of operational risk, if compared with credit or market risk. They recognize its importance but stay short when the objective is to have in place a strong operational risk management practice. They see operational risk management as something that has to be implemented to give answer to the regulations from supervisors and not as a way to reduce operational risk exposure.

Nevertheless, this idea has been changing in the last years, as operational risk management has become part of Corporate Governance. As the organizational culture evolves to create companies more sustainable, more social responsible and more efficient, operational risk is started to become more part of the management process and becoming more relevant in the strategy of financial institutions.

The final conclusion from these meeting here:

- Operational risk management is already part of Portuguese financial institutions;
- But is still seen as a need to answer to supervisors;
- Corporate governance is changing how financial institutions present themselves to the markets;

[11] https://www.bankofengland.co.uk/-/media/boe/files/stress-testing/2018/effectiveness-of-stresstesting-model-risk-management.pdf?la=en&hash=A51580D1B0E894DAA45CAA94EDEC8575F7BA9012

- Operational risk management will be a strong input for a “strong” Corporate Governance
- In the future, Portuguese financial institutions, see operational risk management as a way to improve their processes and business.

It is reiterated that the core reason for having this methodology in our study is the sensitivity of information because we understand the gaps are there and belong to internal set-up of any bank and nobody is ready to accept the responsibility for these short comings.

4. FINDINGS:

From literature review and having some detailed focused group discussions, I have been able to establish the fact that the effective corporate governance and independent operational risk management are directly connected with each other because corporate governance.

The environment wherein effective corporate governance and independent operational risk management not only to improve the quality of internal controls but also help to build an extra-immune system for the bank to absorb any kind to shock over the skin.

5. PROPOSED OR&CG QUADRANT:

The correlation between both elements is an established fact as endorsed by the studies. Therefore, based on our literature review and focus group discussion, the situation may be organized and designed on a quadrant.

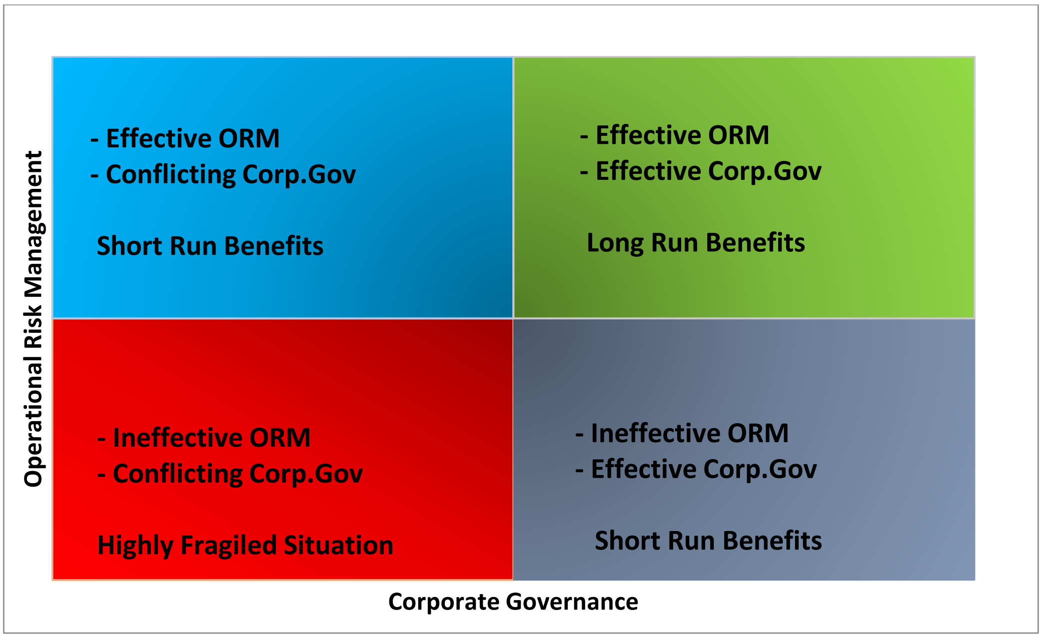


Figure 4: CG & ORM Quadrant, designed by Mahsoon Asif

The above referred quadrant would help to understand severity of situation in any bank. It is a built-in fact that the operational risk management is to make internal environment healthy and sustainable. Subsequently, it creates a buffer zone for the bank to absorbs the shocks from external environmental.

The impact of corporate governance on effectiveness of operational risk management can be more elaborated with the help of following diagrams:

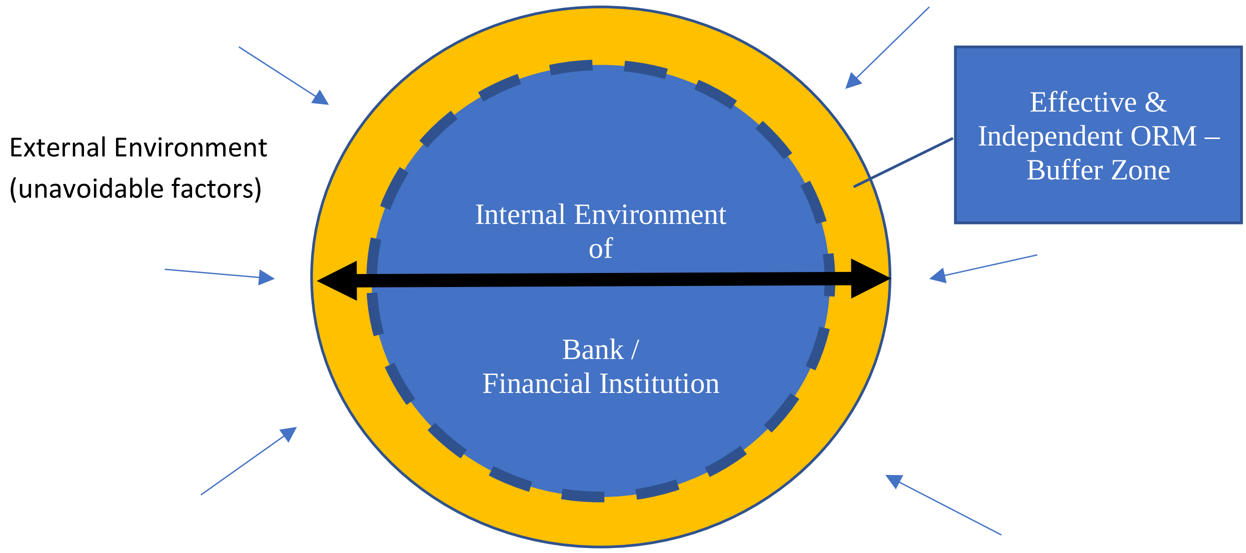


Figure 5: effective CG and Independent ORM, designed by Mahsoon Asif

It is an established fact that the ORM is to control the environment and to improve the sustainability of an organization. The concepts are already there in the industry and need to be adopted in the same spirit as proposed. Unfortunately, the essence of all efforts has been compromised in order to have instant results which put the bank´s sustainability on stake.

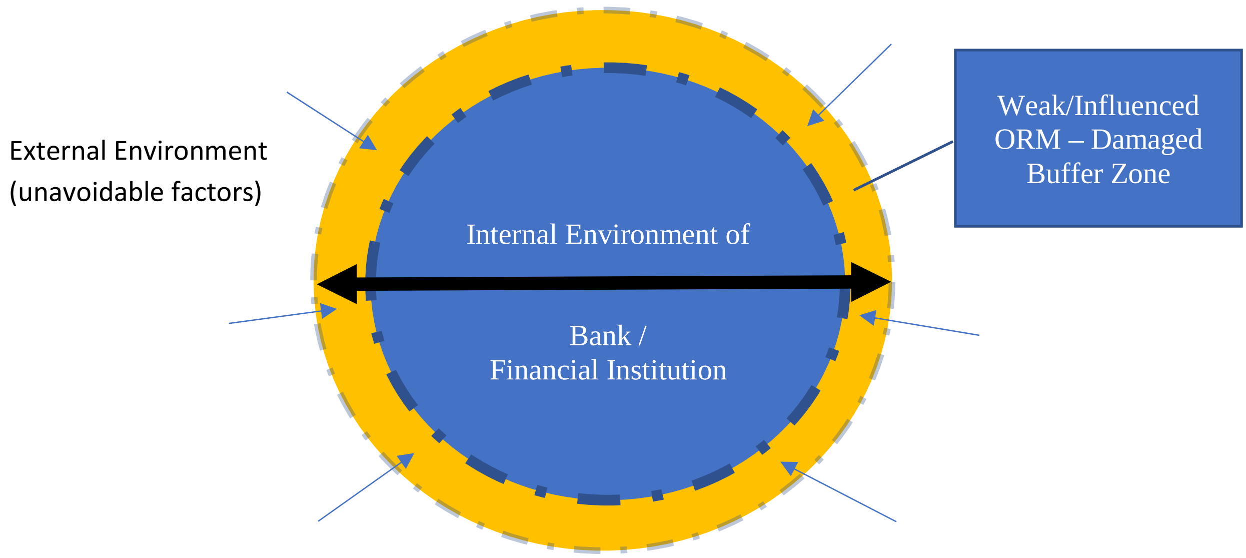


Figure 6: ineffective CG & influenced ORM, designed by Mahsoon Asif

The above referred situation is explaining how the buffer-zone for the bank starts vaporising and bank life become fragile towards any of the external shock.

6. CONCLUSION:

After all the extensive work, literature review & findings, I have been able to establish a direct relationship between effective corporate governance and independent operational risk management in a bank.

The findings highlight that if CG governance plays its role effectively in implementations of regulatory requirements to strengthen the internal controls and develop an independent ORM then bank's sustainability improves. On the other hand, if CG starts influencing the internal controls and procedures which not only affect the performance of a bank but also attract huge operational losses and become fragile for any external stress.

In addition, Banking is considered as backbone for an economy and the product of banking sector is intangible with a tangible impact on economy therefore, pulse rate of internal environment needs to be taken care.

To strengthen banking industry, global and regional regulators are keep working on the policies and regulations to develop a strong internal environment i.e. ORM and CG. The effectiveness of these policies is subject to true adaption. It is also needed to understand here that both components need to work parallel in their respective context. The bank's sustainability can be compromised if any one of ORM or CG would try to affect other's domain.

Hence, the possibility of establishing a direct relationship between effective corporate governance and independent operational risk management in a financial institution has been explored whereas the amount of impact from corporate governance on its operational risk management function varies from situation to situation depending on the demographics & external economic conditions.

Overall, the results of the study illustrate that the influence of corporate governance on operational risk management always has significant impact on the sustainability of a bank therefore, their respective domains should not be overlapping to each other.

7. LIMITATIONS & FURTHER STUDIES:

Researchers can find benefits from the work with latest contribution. The industry would be able to build a better understanding for effective CG and Independent Operational Risk Management which would result into a sustainability and strength for a bank.

The study has been completed with some of the limitations because of new prevailing GDPRs in EU and in most of the cases, banks are reluctant to share the true facts. It was tried to take some of the real example as reference, but the data was not shared due to sensitivity and confidentially. However, the literature review has given enough argument to conclude my studies.

Besides above, the work is still in process and It is being tried to develop a dynamic model to the identify the situation wherein corresponding measures may be taken by the management. However, it would take time and need more expertise. The process has to remain continued in order help the industry to understand qualitative hidden factors. It would also require some support for any legislative body for which efforts are being made.

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