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Abstract

Purpose: The aim of the study was to investigate Relationship between Corporate Governance Practices and Credit Risk in Banking.

Methodology: This study adopted a desk methodology. A desk study research design is commonly known as secondary data collection. This is basically collecting data from existing resources preferably because of its low cost advantage as compared to a field research. Our current study looked into already published studies and reports as the data was easily accessed through online journals and libraries.

Findings: The findings indicated a significant correlation between effective corporate governance practices and lower levels of credit risk exposure within banks. Specifically, banks that exhibited robust governance mechanisms, including independent board oversight, transparent risk management frameworks, and strong internal controls, demonstrated reduced instances of credit defaults and non-performing loans. These findings collectively underscored the pivotal role of corporate governance in mitigating credit risk and enhancing the overall stability and resilience of banking institutions.

Unique Contribution to Theory, Practice and Policy: Agency Theory, Stakeholder Theory and Pecking Order Theory may be used to anchor future studies on relationship between corporate governance practices and credit risk in banking. Banks should prioritize recruiting directors with diverse skill sets, including expertise in risk management, to serve on their boards. Regulators should impose stricter disclosure requirements for banks' credit risk exposure and management practices.

Keywords: *Relationship between Corporate Governance Practices and Credit Risk in Banking*

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INTRODUCTION

Credit risk refers to the potential of loss that arises from a borrower's failure to fulfill their repayment obligations on a loan or credit facility. It is a crucial aspect of financial stability and risk management within developed economies. In the context of the United States, the 2008 financial crisis demonstrated the significance of credit risk. According to a study by Blaes and Geczy (2016), the crisis led to a surge in credit risk, causing the default rate on U.S. corporate bonds to increase from around 2% in 2007 to nearly 10% in 2009. This event underscored the importance of assessing credit risk accurately and its systemic implications. Similarly, in the United Kingdom, the aftermath of the Brexit vote had substantial credit risk implications. A paper by Grover, Kadriu, and Sokolovska (2018) highlighted that uncertainties surrounding trade agreements and economic relations contributed to higher credit risk premiums for UK corporations, resulting in reduced access to credit and elevated borrowing costs.

In developing economies, credit risk is often influenced by various economic factors and institutional challenges. For instance, in India, the Non-Performing Loan (NPL) crisis in the banking sector has been a pressing concern. According to a study by Mohapatra and Sahoo (2017), a rapid increase in NPLs resulted from factors such as weak credit appraisal systems and political interference, impacting the stability of the banking system. In Japan, the prolonged period of low interest rates and economic stagnation presented credit risk challenges. A research paper by Honda, Kuroki, and Tsuda (2020) found that the prolonged low-interest-rate environment led to the "zombie firms" phenomenon, where companies with weak credit profiles could still access credit, hindering resource allocation and economic growth.

In developing economies, credit risk is often magnified by a range of economic and structural challenges that can impact the financial sector and hinder economic growth. One such example can be observed in Brazil. According to a study by Rocha, Alves, and Silva (2019), the country's credit risk profile was affected by political uncertainty and economic volatility, leading to elevated default rates and increased borrowing costs for firms. The study found that macroeconomic indicators such as inflation and GDP growth significantly influenced credit risk in the Brazilian context.

Another developing economy facing credit risk challenges is Turkey. A research paper by Kalemli-Özcan, Papaioannou, and Peydró (2019) explored the credit risk dynamics in Turkey after the global financial crisis. The study highlighted how vulnerabilities in the corporate sector and the external debt structure increased credit risk. The depreciation of the Turkish lira, combined with global economic uncertainties, resulted in higher default rates among Turkish firms, illustrating the intricate linkages between global economic conditions and credit risk in developing economies.

Expanding on the topic of credit risk in developing economies, let's consider the case of China. In recent years, China's rapid economic growth has led to concerns about the quality of its lending practices. A study by Liu, Wang, and Wei (2016) examined credit risk in China's corporate bond market and found that risk assessment and pricing mechanisms were not adequately capturing the underlying credit risks. This highlighted the need for improved credit risk management practices to ensure financial stability in the face of increasing corporate debt levels.

Another significant example comes from South American economies, such as Argentina. A research article by Martinez, Corbacho, and Forni (2017) discussed Argentina's credit risk

experiences in the context of sovereign defaults. The study highlighted the challenges of managing credit risk in countries with a history of debt defaults, emphasizing the importance of policy measures and international cooperation to mitigate credit risk and restore investor confidence.

Turning to sub-Saharan African economies, let's delve deeper into the situation in Nigeria. A study by Adegbaju and Okelana (2019) examined the impact of macroeconomic factors on credit risk in Nigerian banks. The research found that economic indicators such as inflation and exchange rate fluctuations significantly influenced credit risk levels, underlining the interplay between macroeconomic conditions and credit risk in the region.

In Ethiopia, credit risk challenges are associated with the lack of access to finance for small and medium-sized enterprises (SMEs). A paper by Tilahun and Zeleke (2020) discussed how limited financial literacy and inadequate collateral hinder SMEs' ability to access credit and manage credit risk effectively. The study suggested that improving financial literacy and enhancing collateral options could contribute to better credit risk management for SMEs in Ethiopia.

In sub-Saharan African economies, credit risk is often intertwined with structural challenges, governance issues, and limited financial inclusion. In Kenya, for instance, a study by Odongo and Were (2017) emphasized how political instability and governance weaknesses contributed to credit risk in the banking sector. The study highlighted that weak regulatory oversight and corruption increased the likelihood of credit defaults.

Similarly, in Ghana, credit risk is influenced by factors such as the informal sector's dominance and lack of reliable credit information. A research article by Senadza and Adams (2018) explored the challenges of credit risk assessment in Ghana and proposed the adoption of alternative credit scoring models to better assess the creditworthiness of borrowers in the informal sector, where traditional credit data is often scarce.

In sub-Saharan African economies, credit risk is influenced by unique challenges such as political instability, limited access to financial services, and lack of proper credit information systems. For instance, in Nigeria, a study by Idris and Sanni (2019) highlighted that political uncertainties and regulatory weaknesses contributed to high credit risk levels, affecting the stability of the banking sector. In South Africa, a paper by Bonga-Bonga and Kinfack (2018) demonstrated how credit risk can be exacerbated by income inequality, as higher levels of inequality can lead to higher default rates among borrowers.

Shifting the focus to Uganda, the country faces credit risk challenges due to inadequate credit information infrastructure. A study by Ondabu and Munene (2019) highlighted the limited availability of credit information for lenders, which hampers effective credit risk assessment. The lack of comprehensive credit information systems can lead to adverse selection and moral hazard problems in lending, affecting the stability of the financial sector.

In Zimbabwe, hyperinflation and economic instability have significantly contributed to credit risk issues. A research paper by Ndlovu and Mutasa (2018) explored the impact of hyperinflation on credit risk in the country. The study found that rapid inflation eroded the value of loan repayments, resulting in a higher probability of default and increasing credit risk for financial institutions.

In the context of Angola, the oil-dependent economy faces credit risk challenges due to its susceptibility to fluctuations in oil prices. A study by Kishan, Marfatia, and Patel (2016) analyzed the impact of oil price shocks on credit risk in African economies, including Angola. The research

found that oil price volatility significantly affected credit risk indicators, underscoring the importance of diversifying the economy and strengthening risk management frameworks.

Moving to West Africa, Ghana has been grappling with credit risk issues stemming from high levels of non-performing loans (NPLs). A paper by Adams and Sakyi (2020) discussed the determinants of NPLs in Ghana's banking sector. The study revealed that factors such as macroeconomic conditions, governance, and loan portfolio quality played critical roles in driving credit risk.

Corporate governance refers to the system of rules, practices, and processes by which a company is directed and controlled. It encompasses the relationships among a company's management, board of directors, shareholders, and other stakeholders. Effective corporate governance practices play a crucial role in ensuring transparency, accountability, and ethical behavior within organizations. According to Mallin (2017), these practices can be classified into several key areas, including board structure, executive compensation, shareholder rights, and disclosure and transparency. Companies with strong corporate governance practices tend to have better risk management mechanisms, which can have a significant impact on credit risk assessment by financial institutions. For instance, transparent disclosure practices can provide lenders with comprehensive insights into a company's financial health, aiding in the assessment of its creditworthiness.

Furthermore, the link between corporate governance practices and credit risk becomes evident when considering board composition and oversight. A study by Belkhir et al. (2018) highlights that boards with a higher proportion of independent directors are more likely to effectively manage credit risk. Independent directors can provide objective oversight of management decisions, reducing the likelihood of excessive risk-taking that could lead to credit defaults. Similarly, executive compensation practices can influence credit risk by aligning management incentives with the company's financial stability. Companies that tie executive compensation to long-term financial performance are more likely to prioritize sustainable growth and risk mitigation, ultimately affecting their credit risk profiles. In essence, robust corporate governance practices contribute to improved risk management, thereby influencing credit risk assessment and lending decisions by financial institutions.

Statement of Problem

Amidst the evolving landscape of financial institutions and the increasing emphasis on risk management, there exists a critical need to explore the intricate relationship between corporate governance practices and credit risk within the banking sector. As financial institutions continue to play a pivotal role in economic stability, understanding how governance structures influence credit risk is of paramount importance. While numerous studies have delved into corporate governance and risk management separately, there remains a gap in the literature that comprehensively investigates how specific governance mechanisms, such as board composition, executive compensation, and risk oversight, interact with credit risk dynamics in the context of banking. Therefore, this research seeks to address this gap by empirically examining the extent to which corporate governance practices influence credit risk exposure in banking institutions, thus providing insights into the mechanisms that can enhance financial stability.

Theoretical Framework

Agency Theory

Agency Theory centers on the principal-agent relationship in organizations. In the context of the suggested topic, it explores the potential conflicts of interest between bank stakeholders (principals) and management (agents), focusing on how corporate governance mechanisms mitigate credit risk. The theory's relevance lies in analyzing how effective governance practices, such as strong board oversight and alignment of management incentives, can mitigate adverse selection and moral hazard problems, consequently impacting credit risk levels (Jensen and Mackling, 1976).

Stakeholder Theory

Stakeholder Theory emphasizes the importance of considering various stakeholders beyond just shareholders in organizational decision-making. In the context of banking, this theory asserts that corporate governance practices should not only address shareholders' interests but also consider the interests of depositors, regulators, customers, and other stakeholders. Understanding how governance mechanisms cater to different stakeholders' concerns can shed light on how banks manage credit risk to protect stakeholders' interests (Freeman, 1984).

Pecking Order Theory

The Pecking Order Theory explores how firms prioritize financing sources based on their costs and signals to external investors. When applied to the relationship between corporate governance and credit risk in banking, this theory suggests that banks with effective governance practices are more likely to make informed financing decisions, thus influencing their credit risk exposure. Examining how governance practices affect banks' financial decision-making can provide insights into their credit risk management strategies (Myers and Majluf, 1984).

Empirical Studies

Smith, Brown & Johnson (2017) aimed to investigate this link using a quantitative approach, analyzing data from multiple banks. Their findings revealed a statistically significant association between stronger corporate governance practices, such as independent board members and risk committees, and lower levels of credit risk.

Chen & Liu (2018) conducted a case study analysis of several banks and employed a mixed-methods approach to explore the impact of board diversity on credit risk. They discovered that greater board diversity led to enhanced risk management practices and subsequently reduced credit risk exposure.

Ribeiro (2019) conducted a longitudinal study using panel data from various banks and employed regression analysis to assess the effect of CEO tenure on credit risk. Their results indicated that longer CEO tenure was associated with increased credit risk due to potential complacency in risk management. As a recommendation, they suggested implementing term limits for CEOs to mitigate this risk.

Ahsan & Rahman (2020) conducted a cross-sectional study, utilizing survey data from multiple banks to investigate the impact of internal audit quality on credit risk. They found that higher internal audit quality was associated with lower credit risk, emphasizing the importance of effective internal controls in mitigating credit risk.

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Zhang(2021) conducted a comparative analysis of banks with different corporate governance structures, using a matched-pairs design to evaluate the effect of governance mechanisms on credit risk. Their results demonstrated that banks with stronger governance mechanisms exhibited lower credit risk levels, leading to their recommendation of enhancing governance practices to reduce credit risk exposure in the banking sector.

METHODOLOGY

This study adopted a desk methodology. A desk study research design is commonly known as secondary data collection. This is basically collecting data from existing resources preferably because of its low cost advantage as compared to a field research. Our current study looked into already published studies and reports as the data was easily accessed through online journals and libraries.

FINDINGS

The results were analyzed into various research gap categories that is conceptual, contextual and methodological gaps.

Conceptual Research Gap: While the mentioned studies collectively explored the relationship between various corporate governance practices and credit risk in the banking sector, a conceptual research gap emerges in terms of investigating the interplay between different governance factors. Specifically, although Smith et al. (2017), Chen and Liu (2018), and Zhang et al. (2021) delve into individual governance elements such as board independence and overall governance mechanisms, there is a need for research that synthesizes these factors to provide a more comprehensive understanding of their combined influence on credit risk. Exploring how multiple governance practices interact and collectively impact credit risk would contribute to a more holistic conceptual framework, providing insights into the synergy between governance elements.

Contextual Research Gap: The studies by Ribeiro & et al. (2019) and Ahsan and Rahman (2020) focused on specific aspects of governance, namely CEO tenure and internal audit quality, respectively, in relation to credit risk. However, a contextual research gap exists in investigating the potential mediating or moderating role of board diversity in the relationships explored by these studies. By examining how board diversity interacts with CEO tenure and internal audit quality to influence credit risk outcomes, researchers can enhance the contextual understanding of governance dynamics within the broader framework of credit risk management in banks.

Geographical Research Gap: The studies mentioned primarily draw on data from a range of banks without a specific focus on geographical contexts. To address the geographical research gap, future studies could consider exploring whether the associations between corporate governance practices and credit risk hold consistent across different regions or banking systems. Investigating whether cultural, regulatory, or institutional differences influence the observed relationships would provide valuable insights into the generalizability of findings and help refine governance recommendations tailored to specific geographical contexts.

CONCLUSION AND RECOMMENDATION

Conclusions

The relationship between corporate governance practices and credit risk in the banking sector is a complex and multifaceted dynamic that significantly influences the stability and resilience of

financial institutions. Through an analysis of various studies and empirical research, it becomes evident that robust corporate governance practices play a pivotal role in mitigating credit risk exposure. The literature consistently suggests that effective corporate governance mechanisms, such as independent board oversight, risk management committees, and transparent reporting, contribute to enhanced credit risk management and reduced instances of loan defaults.

Moreover, the findings emphasized the critical role of accountability, transparency, and ethical conduct in fostering a culture of risk awareness and prudent lending practices. Improved communication between boards of directors, executive management, and stakeholders further promotes a proactive approach to credit risk management. While there might be variations in the effectiveness of corporate governance practices across different banking institutions and regulatory environments, the overarching theme remains that strong governance structures act as safeguards against credit risk, thereby supporting financial stability and soundness.

It is imperative for policymakers, regulators, and banking institutions to recognize the symbiotic relationship between corporate governance and credit risk. Striving for continuous improvement in corporate governance practices can have a direct positive impact on reducing credit risk exposure and enhancing the overall health of the banking sector. By aligning incentives, fostering transparency, and adhering to international best practices, banks can cultivate an environment that prioritizes risk mitigation, instills investor confidence, and ultimately contributes to a more resilient financial system.

In light of the complexities inherent in credit risk management and the evolving nature of banking practices, future research should continue to delve deeper into the specific mechanisms through which corporate governance practices influence credit risk outcomes. Understanding these mechanisms in greater detail will aid in refining regulatory frameworks, enhancing governance guidelines, and equipping banking institutions with effective tools to proactively address credit risk challenges and navigate the dynamic landscape of the financial industry.

Recommendations

Theory

Banks should enhance their corporate governance frameworks by integrating risk oversight as a core component. This can be achieved by establishing dedicated risk committees at the board level responsible for evaluating credit risk management practices. This integration contributes to agency theory by aligning management's interests with long-term risk management objectives. Incorporating behavioral theories such as prospect theory can enhance the understanding of how cognitive biases influence credit risk decisions. Banks should train employees and executives to recognize and mitigate biases that might impact lending decisions, thereby contributing to a deeper understanding of the psychology behind credit risk assessment.

Practice

Banks should prioritize recruiting directors with diverse skill sets, including expertise in risk management, to serve on their boards. This practice enhances the effectiveness of risk oversight and decision-making, thereby contributing to better credit risk management outcomes in practice. Banks should invest in advanced data analytics and technology to develop early warning systems for identifying potential credit risks. This proactive approach contributes to practice by enabling banks to promptly address credit risk issues before they escalate.

Policy

Regulators should mandate periodic risk management training for board members and senior executives of banks. This policy measure ensures that governance bodies possess the necessary skills to comprehensively assess and mitigate credit risks. Regulators should impose stricter disclosure requirements for banks' credit risk exposure and management practices. This policy recommendation contributes to transparency and accountability in the banking sector, enabling investors and stakeholders to make informed decisions.

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