World Academy of Science, Engineering and Technology
International Journal of Economics and Management Engineering
Vol:10, No:06, 2016

Open Science Index, Economics and Management Engineering Vol:10, No:06, 2016 publications.waset.org/abstracts/44022.pdf

Bank Internal Controls and Credit Risk in Europe: A Quantitative Measurement Approach

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Abstract : Managerial actions which negatively profile banks and impair corporate reputation are addressed through effective internal control systems. Disregard for acceptable standards and procedures for granting credit have affected bank loan portfolios and could be cited for the crises in some European countries. The study intends to determine the effectiveness of internal control systems, investigate whether perceived agency problems exist on the part of board members and to establish the relationship between internal controls and credit risk among listed banks in the European Union. Drawing theoretical support from the behavioural compliance and agency theories, about seventeen internal control variables (drawn from the revised COSO framework), bank-specific, country, stock market and macro-economic variables will be involved in the study. A purely quantitative approach will be employed to model internal control variables covering the control environment, risk management, control activities, information and communication and monitoring. Panel data from 2005-2014 on listed banks from 28 European Union countries will be used for the study. Hypotheses will be tested and the Generalized Least Squares (GLS) regression will be run to establish the relationship between dependent and independent variables. The Hausman test will be used to select whether random or fixed effect model will be used. It is expected that listed banks will have sound internal control systems but their effectiveness cannot be confirmed. A perceived agency problem on the part of the board of directors is expected to be confirmed. The study expects significant effect of internal controls on credit risk. The study will uncover another perspective of internal controls as not only an operational risk issue but credit risk too. Banks will be cautious that observing effective internal control systems is an ethical and socially responsible act since the collapse (crisis) of financial institutions as a result of excessive default is a major contagion. This study deviates from the usual primary data approach to measuring internal control variables and rather models internal control variables in a quantitative approach for the panel data. Thus a grey area in approaching the revised COSO framework for internal controls is opened for further research. Most bank failures and crises could be averted if effective internal control systems are religiously adhered to.

Keywords : agency theory, credit risk, internal controls, revised COSO framework
Conference Title : ICEBA 2016 : International Conference on Economics and Business Administration
Conference Location : San Francisco, United States
Conference Dates : June 09-10, 2016