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Literature Review on the Impact of Risk Management Committees on the Effectiveness of Enterprise Risk Management

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Abstract

The establishment of the Risk Management Committee aims to enhance the board's ability to monitor risks, but there is no consensus on its impact on the effectiveness of enterprise risk management. This article provides a literature review from two aspects: whether the risk management committee will improve the effectiveness of enterprise risk management, and which features will affect the effectiveness of enterprise risk management. Research has found that the structural characteristics of risk management committees, including size, independence, professional knowledge and skills, meeting frequency, and proportion of female members, have a significant impact on the effectiveness of enterprise risk management. However, the relationship between these characteristics and corporate performance is not consistent and may be influenced by moderating variables such as external environmental uncertainty, industry competition intensity, and corporate complexity. This article suggests that companies should establish a reasonable risk management committee based on their own characteristics and consider incorporating digital skills into the professional knowledge of committee members. Future research should consider the impact of specific situational factors on the relationship between risk management committees and the effectiveness of enterprise risk management.

Keywords: Risk Management Committee; Enterprise Risk Management; Structure

1. Introduction

For enterprises, risk is a double-edged sword. High performance often comes with high risk, and conversely, reducing risk may also inhibit the performance of the enterprise. Therefore, effective risk management is crucial for enterprises. Effective risk management can significantly improve a company's performance. Studies have shown that effective enterprise risk management can significantly improve a company's Tobin Q (Hoyt et al., 2011). Gordon et al.(2009)

developed a comprehensive index of enterprise risk management to study the relationship between enterprise risk management and enterprise performance. The research results showed that there is a significant positive correlation between enterprise risk management and enterprise performance, and the strength of this relationship depends on the matching of enterprise risk management processes with the operating environment of the enterprise.

The board of directors, as an effective control mechanism for corporate governance, is responsible to shareholders for the effectiveness of comprehensive risk management work. Therefore, the board of directors plays a crucial role in the implementation of enterprise risk management. According to agency theory, the board of directors should establish a risk management committee to assist in fulfilling its risk management responsibilities and enhance its ability to monitor risks. At the same time, the bankruptcy of enterprises in the early 21st century and the global financial crisis in 2008 have promoted efforts to improve international regulation, with clear requirements for the composition structure of the board of directors. For example, the Sarbanes Oxley Act in the United States requires that the board of directors of listed companies must have no less than 50% independent directors, and the audit committee must be composed entirely of independent directors. The Corporate Governance Committee of the Australian Securities Exchange requires listed companies to establish an independent risk management committee to enhance the regulatory function of the board of directors. Therefore, these regulatory requirements provide a certain foundation for relevant academic research.

At present, there are many studies on the relationship between risk management committees and enterprise risk management, but no consensus has been reached on the results. This article will conduct a literature review from two aspects: first, whether the risk management committee will improve the effectiveness of enterprise risk management, and second, which characteristics of the risk management committee will affect the effectiveness of enterprise risk management. The research aims to explore how the structural characteristics of risk management committees affect the effectiveness of enterprise risk management, and analyze the potential impact of these characteristics on enterprise performance. The goal is to provide theoretical and empirical support for optimizing risk management practices, improving governance structures, and enhancing performance for enterprises, while responding to international regulatory requirements and providing guidance for future research directions.

2. Risk Management Committee and Effectiveness of Enterprise Risk Management

Compared with traditional risk management methods, enterprise risk management adopts a holistic approach of assessing and managing risks and capturing opportunities in an interdependent environment (Farrell et al., 2015). Enterprise risk management requires the integration of risk management into a company's strategic plan. COSO (2004) defines enterprise risk management as a process jointly implemented by the company's board of directors, management, and other personnel, applied to the strategic framework of the entire enterprise, aimed at identifying potential risk events that may affect the enterprise and managing them within risk appetite, thereby providing reasonable assurance for achieving the company's goals (Zhao et al., 2014). Therefore, enterprise risk management requires the board of directors to enhance its ability to supervise enterprise risks.

In fact, many companies have also applied the "Integrated Framework for Enterprise Risk Management" proposed by COSO to their actual risk management activities, especially since the board of directors has established an independent audit committee to assist them in fulfilling their risk monitoring responsibilities. However, the audit committee bears significant responsibilities for both internal control and financial reporting, and therefore cannot effectively handle risk management related matters (Elamer, 2018). Furthermore, the professional knowledge possessed by the audit committee does not fully match the skills required to manage complex risks. More researchers have shown that due to a lack of professional knowledge and additional responsibilities, audit committees do not have enough time to provide optimal risk management solutions to the board of directors. Based on this, some countries in developed economic market regions have further requirements for the structure and composition of the board of directors. In particular, the 2009 UK Walker Report proposed that the board of directors of listed companies should establish an independent risk management committee to monitor current and future risks.

At present, there are many literature studies on risk management committees, but the results have not tended towards consistency. Among them, Yatim (2010) pointed out that an independent risk management committee has a positive impact on the performance of a company. In addition, Minton et al. (2011) conducted a study using data from 235 banks in the United States, and the results showed a positive impact between risk committees and corporate financial performance. Meanwhile, Jia et al. (2020) conducted an empirical study on the relationship between risk management committees and corporate performance using data from non-financial listed companies in Australia. The study found that companies with independent risk management committees performed better than other companies. From this, it can be seen that the risk management committee can increase corporate performance by strengthening the effectiveness of enterprise risk management. Malik et al.(2020) precisely validated this pathway. In addition, risk management committees can prevent companies from falling into financial difficulties by reducing the likelihood of tail end risks (Beasley et al., 2008). Zhou et al.(2020) pointed out that risk management committees can reduce information asymmetry by strengthening supervision of managers, which can help companies reduce a certain degree of risk.

However, Aebi et al.(2012) suggest that a risk management committee may not necessarily be a feasible solution to improve the effectiveness of risk management, as establishing a risk committee would increase the corresponding costs but would not eliminate all risks. An empirical study using data from listed companies of Malaysian investment banks showed that companies with risk management committees exhibited poorer performance. Meanwhile, Zemzem and Kacem (2014) studied the relationship between risk committees and corporate financial performance using data from 2002 to 2011, and the results showed a negative correlation between risk management committees and corporate financial performance. Further research has shown that there is no significant relationship between risk management committees and corporate performance.

The reason may be that different enterprises have different structural characteristics when establishing risk management committees, and risk management committees with different structural characteristics play different roles in fulfilling risk regulatory responsibilities, resulting in inconsistent research results. As Kallamu (2015) pointed out, if the risk management committee cannot operate effectively, its establishment cannot increase any revenue for the enterprise. Therefore, having a strong risk management committee is necessary for enterprises.

3. Structural Characteristics of Risk Management Committee and Effectiveness of Enterprise Risk Management

At present, most of the literature on the structural characteristics of risk management committees focuses on the committee's size, independence, professional knowledge and skills, number of committee meetings, and whether the committee has female members. This section will also conduct a literature review from these five aspects.

3.1. Scale of Risk Management Committee

The composition of the committee has a significant impact on its efficiency in performing its duties. Although regulations in various countries do not specify the number of committee members, it is usually emphasized that the number of members should be reasonable. Smith (2003) pointed out that the risk management committee should have at least three members, while Vafeas (2005) believes that having too many members may lead to free riding problems.

Empirical research shows that there is a certain positive relationship between committee size and corporate performance. For example, increasing the size of the risk management committee can enhance supervision of managers' risk management behavior, ensure that investments align with strategic goals, and thereby avoid financial crises by reducing adverse choices and moral hazard (Aebi et al, 2012; Yatim, 2010. This viewpoint is consistent with agency theory. In addition, according to the resource dependence theory, larger committee sizes can gather more professional knowledge, thereby providing more constructive recommendations to the board of directors (Bédard et al., 2004).

However, other studies suggest the opposite view. The empirical research by Kakanda (2018) and Malik (2021) suggests that committee size may have a negative impact on firm performance. Similarly, Elamer's(2018) study on UK financial institutions found a negative correlation between the size of risk management committees and financial performance. This negative impact may stem from communication barriers caused by an excessive number of members, which can exacerbate conflicts between shareholders and management and ultimately damage corporate performance. The study by Wu et al. (2009) on board size further supports this conclusion. In addition, the expansion of the committee size may also lead to an increase in agency costs, which may have a negative impact on corporate performance. Therefore, the board of directors of a company should establish a reasonable number of risk management committees based on its own development characteristics.

3.2. Independence of the Risk Management Committee

The agency theory suggests that the board of directors should be equipped with an appropriate number of external directors to ensure their independence, thereby effectively supervising managers and providing objective recommendations to the board. This is because external directors are more concerned with their own "reputation" rather than focusing on economic interests. Therefore, they are able to better fulfill their regulatory responsibilities.

The US Sarbanes Oxley Act provides clear regulations on how many independent directors a board of directors should have, requiring that the board of directors of US listed companies must have no less than 50% independent directors. However, there is no clear regulation on the number of independent directors in the risk management committee.

Existing research indicates that there is no consensus on the relationship between the independence of risk committees and corporate performance. A study conducted by Zemzem and Kacem (2014) on Tunisian loan companies showed that the percentage of independent members in the risk management committee is positively correlated with corporate performance. Kallamu et al.(2013) also found a positive correlation between the percentage of independent directors in the risk management committee and a company's financial performance, and found a positive correlation between the percentage of independent directors in the risk management committee and the company's market valuation. These results are supported by agency theory, which suggests that the more independent members a board of directors has, the higher the degree of control and objectivity in decision-making.

However, an empirical study conducted by Yeh et al.(2011) showed a negative correlation between the independence of risk management committees and a company's financial performance. Meanwhile, an empirical study conducted by Elamer (2018) on the impact of risk committees on the financial performance of UK financial institutions confirmed a negative correlation between the independence of risk management committees and financial performance. These results are supported by the stewardship theory, which suggests that due to the lack of relevant operational information of the enterprise by external directors, even if they can excessively supervise the enterprise, it will lead to a decrease in the value of the enterprise. In addition, unnecessary regulation can hinder management from making decisions in accordance with the company's goals. In addition, research on the impact of independent directors on corporate risk management has shown that a large number of independent directors can lead to excessive use of interest rate derivatives, resulting in high risks for the company and a decrease in its valuation.

Therefore, when setting up a risk management committee, the board of directors of a company should not only consider the number of independent boards, but also the degree to which the committee has access to company information, in order to establish a strong risk management committee.

3.3. Professional Knowledge and Skills of the Risk Management Committee

As the main responsibility of the Risk Management Committee is to manage risks on behalf of the Board of Directors and monitor the behavior of managers. Therefore, it must possess some risk management knowledge that the current board of directors does not possess.

Kallamu(2015) pointed out that directors with financial knowledge can better understand the complexity and risks of the committee. Xie et al. (2001) argue that directors with only financial knowledge may make more unfavorable decisions, leading to higher costs. Studies have shown that during financial crises, committee members with financial knowledge did not avoid losses. Therefore, financial knowledge is not sufficient to become a necessary skill for managing risks. When establishing a risk management committee, the board of directors of a company should consider whether the members have experience in risk management, such as whether they have served as the chief risk officer or have experience in risk management.

3.4. Frequency of Risk Management Committee Meetings

Smith (2003) pointed out that the risk management committee should hold at least three meetings a year. The main purpose of establishing a risk management committee by the board of directors is to ensure that risks can be regularly evaluated and managed. The committee members communicate effectively through regular meetings to avoid delays in risk management actions. In addition, the number of meetings of the Risk Management Committee can also reflect the level of effort it has put in to complete its tasks.

An empirical study by Aebi et al.(2012) showed that the frequency of risk management committee meetings has a significant positive impact on the performance of Bank of America. Meanwhile, the research conducted by Kakanda(2018) using data from listed financial services companies in Nigeria showed that the frequency of risk management committee meetings has a significant positive impact on a company's book to book ratio (MTB). Hoque et al.(2013) found no significant relationship between the number of risk management committee meetings and corporate financial performance.

However, studies have shown that high-frequency committee meetings are only effective during times of crisis, and an increase in the number of meetings during normal times can lead to increased costs, thereby having a negative impact on business performance. Ng et al. (2012) found that the number of risk management committee meetings is negatively correlated with corporate financial performance. Meanwhile, a study conducted by Elamer(2018) using data from UK financial institutions also confirmed a negative correlation between the number of risk management committee meetings and corporate financial performance. Therefore, the frequency of committee meetings should be determined based on the performance of the committee itself and the characteristics it aims to accomplish its tasks.

3.5. Female Members of the Risk Management Committee

Behavioral theory suggests that the behavior of a committee is related to its gender composition. Loukil and Yousf (2016) pointed out that female directors tend to be more averse to risk than male directors in risk related decision-making. Meanwhile, Campbell and Minguez Vera (2008) pointed out that female directors are more likely to improve a company's performance by enhancing its innovation capabilities. Malik et al. (2020) conducted an empirical study that precisely demonstrated a significant positive relationship between female members of risk management committees and company performance.

However, the study by Adams and Ferreira (2009) suggests that female boards excessively regulate risky decisions, to the extent that it harms the interests of shareholders. In addition, their research also found that arranging female directors in committees is just a symbol for companies. The empirical research results of Kakanda (2018) precisely confirm this point. There is a significant negative relationship between female directors of the risk management committee and the market value of the enterprise. Therefore, when considering the gender of members of the risk management committee, the board of directors of a company should determine it based on the actual situation of the company. Female directors should not be seen as a symbol, nor should high-yield venture capital be abandoned due to the supervision of female directors.

4. Conclusion

In summary, the risk management committee can improve the effectiveness of enterprise risk management under certain conditions, thereby increasing the performance of the enterprise. The certain conditions are reflected in the fact that the risk management committee must have the advantage of risk control in its structural composition, including having a reasonable scale, a reasonable number of independent directors, corresponding knowledge of risk management, and holding a reasonable number of meetings based on the operation of the enterprise, and considering whether to include female directors based on the characteristics of enterprise risks. In short, a strong structured risk management committee can help the board better fulfill its responsibilities in risk control. Jia et al. (2020) constructed a comprehensive index of the structural characteristics of risk management committees to examine the impact of best practices in risk management on corporate performance. The results further confirmed that companies with strong risk committee structures have better corporate performance.

However, the relationship between the Enterprise Risk Management Committee and the effectiveness of enterprise risk management may be influenced by some moderating variables, such as the uncertainty of the external environment of the enterprise, the intensity of competition in the industry in which the enterprise operates, and the complexity of the enterprise. Existing research has not considered the impact of these special factors on the relationship between the two. Therefore, when studying the impact of risk management committees on the effectiveness of enterprise risk management, certain specific contextual factors should be considered.

Furthermore, as mentioned earlier, the audit committee, as a committee under the board of directors, bears significant responsibilities for internal control and financial reporting. The structural characteristics of the audit committee are related to the quality of the company's financial statements and information disclosure. According to COSO (2004), enterprise risks are divided into strategic risk, operational risk, compliance risk, and reporting risk. Therefore, audit committees also have a certain impact on the effectiveness of enterprise risk management.

Therefore, it is necessary to simultaneously consider the impact of the characteristics of the risk management committee and the audit committee on the effectiveness of enterprise risk management, as existing literature studies these two separately.

Finally, in the era of enterprise digital transformation, digitization can be seen as an environmental factor that can influence the structure and functionality of a company, and this factor further affects the implementation of enterprise risk management. Therefore, committee members should possess corresponding digital skills. However, existing literature only considers knowledge related to accounting and risk management when studying the impact of committee expertise on the effectiveness of enterprise risk management, without taking into account corresponding digital skills. Therefore, future research can consider using digital skills as a factor that affects the effectiveness of enterprise risk management.

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