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BEST PRACTICE OF ENTERPRISE RISK MANAGEMENT: THE IMPACT ON RURALS' BANK PERFORMANCE

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Abstract: This research aims to examine the role of enterprise risk management (ERM) on rural banks' performance. ERM is measured by the structure, governance, and process in the risk management process. The bank performance as the dependent variable use measurement both financial and non-financial. The study sample is the rural banks in Riau Island provinces, consisting of 63 questionnaires as the data for further analysis. The result showed that ERM enhances the rural banks' performance, both financial and non-financial. It showed that the practice of ERM does well when the rural bank is well-established.

Keywords: *enterprise risk management, bank performance, rural banks*

1. Introduction

A firm has an objective to achieve good performance and create maximum value for stakeholders, but in that case, the firm will also face risks. Risk is an uncertainty that affects a firm's ability to achieve its goals and will have negative or positive results (Salaudeen, Atoyebi, & Oyegbile, 2018). This risk occurs due to changes in the business environment, competition, technological developments, globalization, and complex corporate structures (Kaya, 2018). Firms need a risk management tool to avoid and mitigate risk to the lowest level to survive in the competition. It shows that it is essential for a firm to implement effective risk management (Iswajuni, Manasikana, & Soetedjo, 2018).

ERM is risk management related to good corporate governance (GCG) and can add a holistic perspective to the firm's risk management process. ERM is an integral part of corporate governance and strategy (Bogodistov & Wohlgemuth, 2017). ERM will also optimize firms that consider risks in formulating strategies and business objectives in achieving the results (COSO, 2017). Firm performance can be improved through the implementation of ERM. ERM improves firm performance by ensuring that firm resources can implement risk management (Salaudeen, Atoyebi, & Oyegbile, 2018). Research conducted by Annamalah *et al*. (2018) shows that the implementation of ERM can reduce operational risks, market risks, political risks, health, security, and environmental risks improve firm performance. The link between ERM and firm performance is also influenced by the size and age of a firm, as in the Financial Services Authority Regulation concerning implementing risk management in rural banks. The larger size of the rural bank is required to manage a more significant number of types of risk, and the age of a rural bank also determines how mature the level of risk management is (Florio dan Leoni, 2017).

2. Theoretical Framework

Enterprise risk management (ERM) is a series of business activities that focus on operational reporting, impact, and application of risk to achieve business objectives. Risks can deviate positively or negatively from the planned plan. Risk management is related to performance, aims to grow the company, and prepares a better basis for decision-making (Klučka & Grünbichler, 2020). ERM represents the leading paradigm, supporting organizations to identify, evaluate and manage risk at the company level. The likelihood of financial difficulties and associated costs, low-profit performance, growth opportunities, and board independence are the factors that motivate companies to engage in the ERM process. In addition, the right risk management strategy can be a competitive advantage in supporting the company to grow. Implementing the ERM program is essential in various domains: banks, insurance, and non-financial companies (Anton & Nucu, 2020).

According to McShane (2018), the application of ERM is change management that defies planning procedures and protects companies in an ever-changing environment. Long-term planning where locking down decisions can lead companies on the wrong track. Effective implementation of ERM will result in a sustainable organization in a complex, interrelated, and full of change business world. ERM is a response to deal with risks and uncertainties from internal and external factors facing the organization. ERM provides a process-oriented framework following a holistic approach to risk.

The study of ERM system and implementation problem on financial performance by Hameed *et al*. (2020) on Malaysia listed firms concluded that the ERM system increases companies' financial performance. Risk management practices have a crucial role in firm performance and creating value for shareholders. Similar research is also shown in Annamalah *et al*. (2018), which concluded that ERM improves firm performance in capital costs, profitability, and shareholder value. ERM implementation provides many benefits for companies, such as reducing risk profiles, reducing revenue volume, increasing management assurance in business operations and risk monitoring, improving business reputation, improving decision-making processes, increasing profitability, and creating competitive advantage. ERM implementation is considered a strategic instrument for organizations to achieve success. The same research results were also shown by Soliman *et al*. (2018).

Yang *et al*. (2018) concluded that formal ERM practice could help companies achieve a competitive position and superior performance financially and non-financially. Companies that have a formal implementation of ERM practices have superior performance than companies without ERM. Companies with a high ERM maturity level and ERM index will also have better performance (Soliman & Adam, 2017). ERM practice can reduce various types of exposure and reduce risk exposure (Florio & Leoni, 2017). Rasid, Golshan, Mokhber, Tan, and Zamil (2017) researched ERM and performance measurement systems (PMS) on the firm performance of public listed companies in Malaysia. The result showed that ERM and PMS improve firm performance. Research by Teoh *et al*. (2017) with the COSO ERM framework concluded that ERM implementation could improve firm performance, both financial and non-financial.

The research by Lai and Shad (2017) showed that ERM implementation is an essential factor in increasing profitability and reducing the company's capital costs. The implementation of ERM makes it easier for companies to access the debt market and reduces

systematic risk to reduce the cost of capital for the company. ERM provides accurate guidance for decision-making, planning, control, and implementation. ERM also increases risk awareness in making operational and strategic decisions to enable management to meet strategic objectives, reduce revenue volatility, and increase profitability (Saiful, 2017).

The benefits of ERM are minimizing the cost of capital, reducing the volatility of earnings and share prices, gaining a competitive advantage, increasing decision-making abilities, and building trust for investors. ERM adoption can improve the performance of a company. The result was stated by Rasid *et al*. (2017). Successful ERM implementation also increases shareholder value through savings in capital costs. Ibrahim and Esa (2017) concluded that ERM could improve firm performance through making the right decisions and increasing accountability. The research of Soltanizadeh *et al*. (2016) showed that the implementation of ERM has a significant positive effect on firm performance. ERM can reduce the company's expected tax schedule, underinvestment, managerial compensation, financial distress costs, and external financing. Research by Rasid *et al*. (2014) conducted on financial companies in Malaysia showed that ERM plays a vital role in improving performance. Based on the previous researches, the hypothesis developed as:

H_1: Good practice of ERM increases the performance of rural banks.

H_2: Good practice of ERM increases the financial performance of rural banks.

H_3: Good practice of ERM increase the non-financial performance of rural banks.

3. Research Method

This study uses a quantitative method by using primary and secondary data. Data collection is done by distributing questionnaires and collecting financial data from the rural banks' financial reports. The respondents of this study are the director of rural banks in Riau Island provinces, which consists of 82 respondents. There were 63 from 82 questionnaires collected with a response rate of 76.83%. The ERM is measured by three components: structure, governance, and process (Teoh *et al*., 2017). The dependent variable, bank performance, is measured using return on assets and return on equity as the financial performance (Menicucci & Paolucci, 2016). The non-financial performance uses four indicators: quality, delivery of service, personnel development, and productivity (Rasid *et al*., 2014). The control variables used in this study are bank age and bank size.

4. Results and Discussion

4.1 Results

The outer model test examines the validity of each indicator and the reliability of variables. Table 1 below shows the validity and reliability test result. The inner model test examines the path coefficient.

Table 1. Validity and Reliability Test

Variable	AVE	Cronbach's Alpha	Composite Reliability
Bank Performance	0.842	0.937	0.955
Enterprise Risk Management	0.565	0.933	0.943

Source: Processed Data (2021)

Table 2 shows the result of the path coefficient test. The effect of ERM on bank performance shows a coefficient of 0.736 with a P-Value of 0.000. It means that ERM has a significant positive effect on bank performance. Hypothesis 1 has been accepted. The effect of ERM on bank financial performance shows a coefficient of -0.355 with a P-Value of 0.022. It means ERM has a significant negative effect on bank financial performance. Hypothesis 2 has been rejected. The effect of ERM on bank non-financial performance shows a coefficient of 0.703 with a P-Value of 0.000. It means ERM has a significant positive effect on bank non-financial performance. Hypothesis 3 has been accepted.

Table 2. Path Coefficients

Hypothesis	Coefficients	P-Value	Result
Enterprise Risk Management → Bank Performance	0.736	0.000	Accepted
Enterprise Risk Management → Bank Financial Performance	-0.355	0.022	Rejected
Enterprise Risk Management → Bank Non-Financial Performance	0.703	0.000	Accepted

Source: Processed Data (2021)

The inner model test also examines the path coefficient of control variables. Table 3 shows the result of the path coefficient test. The effect of bank age on bank performance shows a coefficient of -0.347 with a P-Value of 0.011. In contrast, a coefficient of 0.005 with a P-Value of 0.966 showed bank size's effect on bank performance.

Table 3. Path Coefficients (Control Variables)

Direct Effect	Coefficients	P-Value	Result
Bank Age → Bank Performance	-0.117	0.170	Negative
Bank Size → Bank Performance	-0.075	0.481	Insignificant

Source: Processed Data (2021)

4.2 Discussion

The result is supported by the COSO (2017) framework, which states that the bank's ERM integration can help growth and performance improvement. ERM increases a bank's resilience or ability to anticipate and respond to change by identifying risks. Yang *et al*. (2018) stated that formal ERM practices could improve firm performance. ERM minimizes costs arising from financial difficulties, income volatility, and adverse shocks to financial

markets and improves select investment opportunities. ERM plays a role in reducing various types of exposure and risk exposure. The same research results are shown by Florio and Leoni (2017); Soliman and Adam (2017).

Improved integration of risk assessment and management balances threats and opportunities. Threats can be in the form of reduced costs and opportunities to provide profitable investment opportunities. It will increase its cash flow and provide additional operational benefits that support improved performance (Callahan dan Soileau, 2017). Annamalah *et al*. (2018) and Soliman *et al*. (2018) also concluded the same results. ERM is considered a strategic instrument for firms to achieve success. ERM guides decision-making, planning, control, and implementation. ERM also increases awareness of risks and information on risk profiles. Firms can reduce the cost of capital by sharing information about risk profiles, thereby reducing information asymmetry within the firm. The results of this study are shown by Lai dan Shad (2017), and Saiful (2017).

The results of research by Ibrahim and Esa (2017) show that ERM can improve firm performance through making the right decisions and increasing accountability. The results of research that show that ERM can support the improvement of firm performance are also shown by Kasim and Hanafi (2017); Rasid *et al*. (2017); Obwogo *et al*. (2017); Soltanizadeh *et al*. (2016); Shad and Lai (2015); Rasid *et al*. (2014).

5. Conclusion

This research studied the effect of ERM on the rural banks' financial and non-financial performance. It showed that ERM improves the bank performance, but it only showed a positive effect on non-financial performance. The implementation of ERM can enhance the rural banks' performance.

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