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# Banking risks and management strategies

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**Abstract**--This article examines the different types of risk faced by commercial banks, as well as strategies for managing them. It begins by defining the concepts of banking risk, distinguishing between risk and uncertainty, and presents the main categories of risk: financial (such as credit risk, liquidity risk, market risk, interest rate risk and currency risk), operational (such as financial fraud, cybercrime, and legal risks), and other (strategic, reputational and country). The article also explores banking risk management strategies, focusing on both traditional (such as credit risk management) and modern (such as securitization and global risk management) methods. Finally, it concludes with the importance of effective risk management in ensuring bank stability and profitability.

**Keywords**--Banking risk, Credit risk, Market, Operational risk, Traditional Banks' Risks, Management.

## 1. Introduction

Commercial banks, due to the nature of their operations and changing economic conditions, face a variety of risks that can affect their performance and stability. Managing these risks is crucial to maintaining customer and investor confidence, and ensuring long-term profitability. This article aims to explore the different types of risk to which banks are exposed, and the strategies in place to manage them effectively. By examining the concepts of risk and uncertainty, and distinguishing between different types of risk, this article seeks to provide an in-depth understanding of banking risk management.

The following problem statement is presented: **How can commercial banks effectively identify, measure and manage the various types of risk they face in order to minimize potential losses and ensure stable, sustainable performance?**

This research aims to explore the effectiveness of these risk through three main hypotheses. First, the first hypothesis focuses on Banks that apply rigorous financial risk management strategies, such as credit and liquidity risk monitoring, are more successful in minimizing losses and maintaining profitability during economic turbulence. Second, the second hypothesis examines effective management of operational risks, such as fraud and cybercrime, relies on robust internal controls and staff awareness, which can reduce risk incidents. Finally, Banks that adopt both traditional and modern risk management strategies are better prepared to diversify their risks, optimize their capital and ensure their long-term resilience. Through these hypotheses, The research provides an overview of the types of risks faced by commercial banks and the management strategies for mitigating them.

## 2. Methodological approach

### 1. Types of Banking Risks

Commercial banks face many risks as a result of performing their functions, especially in light of the changing economic conditions, and below we can address the types of these risks.

#### 1.1. The concept of banking risk

Before addressing the concept of banking risk, a distinction will be made between risk and risk as follows:

– **Risk:**

Risk is considered to be one of the most significant issues affecting projects, particularly in the banking sector. Indeed, the concept of risk can be understood from several perspectives. According to (Gul Farhat, 2008) risk is a threat resulting from an event likely to compromise an element of the organization, which could adversely affect its ability to achieve set objectives, particularly strategic objectives. This definition underlines the potential impact of risk on the organization's ability to achieve its long-term goals.

On the other hand, (Moncef, 2009) defines risk as a specific harm associated with a fully describable event or set of events whose occurrence is uncertain, but whose possibility is recognized. This definition highlights the uncertain but potentially foreseeable nature of risk, implying that although we cannot always predict with certainty whether an event will occur, we are aware of its possibility and possible consequences.

- **Banking risk** is the fluctuation in the market value of the bank and this risk is divided into two types; what is beyond the control of both the bank and the customer, such as inflation risk, the risk of changing interest rates, exchange rates... In general, bank risk is related to the condition of recovering borrowed capital or collecting expected future profits (Habbar Abdul Razzaq, 2008)

– **As for risk, it is:**

High uncertainty is directly associated with high risk, as uncertainty signifies a lack of knowledge about future events. Therefore, risk can be understood as the degree of uncertainty inherent in a given situation (Al-Nuaimi et al., 2007, p. 135). This definition highlights that the greater the uncertainty, the higher the risk, reflecting the difficulty in predicting future events with certainty.

Regarding banking risk, it is defined as the possibility that a bank may face unexpected and unplanned losses, as well as fluctuations in the expected

return on a particular investment. This definition captures the perspective of internal auditors and managers, who express concerns about the negative effects of potential future events that could impact the achievement of the bank's approved objectives and the successful implementation of its strategies (www.bab.com) This view underscores the importance of managing risks to ensure the stability and long-term performance of the banking institution.

From the above, we conclude that risk is the cause of loss, while risk is a condition that may create or increase the chance of a loss arising from a risk, and something can be both a risk and a risk.

## **1.2. Banking Risk Management Concept**

### **Risk management is defined as:**

Risk management involves the process of measuring or assessing a risk and then developing strategies to manage that risk. Generally, these strategies aim to either divert the risk to another area, avoid the risk altogether, minimize its negative impact, or accept some or all of the consequences associated with the risk (Nadia). This approach ensures that risks are handled proactively and effectively to mitigate their potential adverse effects.

In the context of banking, risk management refers to the activities designed to control and reduce risks to acceptable levels. Specifically, it encompasses the process of identifying, measuring, controlling, and reducing the risks faced by a bank or financial institution. This process is crucial for implementing the bank's strategic objectives (Hammad., 1999, p. 222) Effective risk management is essential for maintaining the stability and success of the institution, ensuring that risks are managed in alignment with its overall strategy.

From these definitions of risk management, we can draw several conclusions:

- Risk management is an integral component of strategic management within a bank.
- It focuses on discovering and understanding potential influences that could adversely impact the bank.
- Risk management involves finding appropriate solutions to address various types of risks, including physical, financial, or moral.

## **1.3. The importance of risk management**

The main objective of risk management is to measure risks in order to monitor and control them, and there are several roles assigned to risk management, the most important of which are:

- Implementing the bank's strategy by providing it with a better view of the future and the ability to determine business policies, in addition to controlling and controlling the uncertainty surrounding the expected gains.
- Developing competitive advantages.
- Measuring capital adequacy and solvency.
- Assisting in decision-making by monitoring inherent risks prior to decision-making and giving the board and executives a holistic view of all risks faced by the bank.
- Assist in making pricing decisions.
- Reporting and controlling risks.

- Establishing a system of internal control to manage the various types of risks in all units of the bank; ensuring that the bank obtains an appropriate return for the risks it may face; (Hammad, 2001 , p. 223)
- Using risk management as a competitive weapon.

The importance of risk management includes:

- Ensuring the adequacy of resources following a loss.- Minimizing the cost of dealing with pure risk.
- Performing legal and contractual obligations.
- eliminating anxiety.

## **2. Types of Banking Risks**

There are several divisions of banking risks, some of which are divided into financial and operational risks. In addition to other risks that can be clarified as follows:

### **2.1 Financial risks**

Financial risks include all risks related to the management of assets and liabilities related to this type of risk requires continuous control and supervision by bank management according to the direction and movement of the market, prices, commissions, economic conditions and the relationship with other related parties, and banks achieve through the risk management method a profit or loss. It is divided into:

### **2.2 Credit risk**

This is the risk that results from the failure of borrowers to repay their obligations, whether in whole or in part, but if the financial institution receives the principal plus interest in full, there is no credit risk, but if the borrowers go bankrupt or have problems that prevent them from paying, the financial institution may lose the return on its funds only or the return and part of the Credit principal or both (Nihal Farid Mostafa, 2007, p. 287). Default or non-payment may result from:

- Accumulation of interest on the customer leading to an inability to repay it.
- Failure to repay the principal as agreed upon.
- Failure to make submersible payments, which are those amounts that are set aside to pay these obligations when they are required.
- Failure to meet any of the bank's liquidation conditions, i.e. exit.

### **2.3 Liquidity risk:**

Liquidity risk is defined as the type of risk to which financial institutions are exposed when the maturities of their uses (loans, and thus become unable to meet the payment requests made by their customers (depositors) and unable to borrow from the market, due to the lack of confidence of lenders in them to pay them in the future. (spesifique, p. 17)

Banks are exposed to this type of risk due to reasons related to the liability side, which is the inability of the bank to meet the large and unexpected demands for withdrawals of deposits by depositors and reasons related to the asset side, which is the unusual demands faced by the bank to fulfill its credit commitments, thus the emergence of credit liquidity risk. (deconsserques, 1996, p. 207)

#### **2.4 Market risk:**

Market risk is the change in the net value of an asset due to (unfavorable) changes in economic factors that lead to a decrease in the value of the bank's financial portfolios, including changes in interest rates, exchange rates, risks associated with the prices of goods, raw materials and derivative products, as well as the risk of changes in stock prices. (Sharon, 2007 , p. 76)

#### **2.5 Interest rate risk:**

The interest rate is the price at which the bank obtains resources (the interest rate granted by suppliers) or on the basis of which the bank utilizes these resources (the interest rate paid by borrowers) (deconsserques, 1996). Interest rate risk refers to the underlying variability in the bank's net interest income and market value of equity relative to changes in market interest rates. This includes the overall composition of the bank's portfolio, the maturity profile of its assets and liabilities, as well as fundamental changes in interest rates. (Samira Saadoun, 2008).

#### **2.6 Exchange risk:**

is the conversion of foreign currency into local currency when conversion rates are unpredictable or constantly changing  
Second requirement: Operational risk

### **3. Operational risk:**

Is the probability that operating expenses will change significantly from what is expected, causing a decrease in the bank's returns, and operational risk is closely related to the number of departments or branches and the number of employees (Qurtubi, 2004, p. 84)

In other words, operational risks arise as a result of inaccuracies in the execution of various operations, i.e. making a mistake, or the failure of operating systems to respond to certain instructions or laws. This type includes the following risks:

#### **3.1 Financial fraud and embezzlement:**

Through the loosening of internal controls and control procedures, such loosening may lead to financial losses as a result of error, fraud, or failure to perform in a timely manner or cause the bank's benefits to be settled in one way or another, for example through its dealers or Credit officers by exceeding their powers or by practicing unethical acts. 7

### 3.2 Cybercrime

These crimes are considered one of the most common crimes and are represented in the following main areas:

- ATMs.
- Credit cards.
- Point of sale.
- Internal embezzlement through employee complicity.
- Automated data exchange.

**3.3 Professional risks** such as negligence and liability risks.

### 3.4 Legal risk

This risk relates to losses due to legal or regulatory action that invalidates the contract or related liquidation arrangements - such risks can arise, for example, from inadequate contract documentation, inability to arrange liquidation of the contract in bankruptcy, or adverse or adverse changes in tax laws. (Shadifat, 2001, p. 266).

### 3.5 Other risks

In addition to the previous risks, there are other risks that banks can be exposed to:

- **Strategic risks:** It is those risks that arise as a result of the absence of strategic planning in the bank, and the strategy is the main path that the bank takes for itself to achieve its goals in the short and long term in light of the general environmental conditions and the conditions of competitors and depending on the transfer of self-strength, and it is difficult to provide quantitative measures in practice to measure strategic risks, but the development of the bank's overall performance from one year to another gives an indication of the extent of the bank's success in strategic planning, and recently the number of banks that disclose their future vision and future strategic planning has increased, which means giving a clear picture to users of financial rules to identify future developments. Financial rules in identifying the future developments of the bank's activity. (Fattah, 2006, p. 120)
- **Reputational risk** This risk arises as a result of failure in the proper operation of the bank that is not in line with the relevant laws and regulations, and reputation is an important factor for the bank as the nature of the activities performed by banks depends on a good reputation with depositors and customers
- **Country risk:** Country risk is the principal loss of interest or capital borrowed internationally due to the refusal to make payments on the maturity date.

## 4. Bank Risk Management Strategies

There are traditional and modern strategies.

#### 4.1 Traditional banking risk management strategies

Considering that there are several risks, each risk will have its own management.

- **Credit Risk Management:**

The main objective of credit management as defined by the financial analyst (sinkey1989) is to maximize profitable sales and thus add value to the company by granting loans to reliable customers.

The decision to grant or deny credit must be made for each application, if the decision is positive, then the next step is to determine the value or size of the credit granted, evaluate, identify and monitor credit areas, almost all business transactions depend on credit because it is the blood artery or the lifeblood of various sectors and reaches the daily life of any member of the human race (Abu Karsh, 2005, p. 5) There are several criteria and methods for assessing credit risk, including: 5Cs Method, LAAP Method, Impression Method, PS Method and Financial Analysis Method.

- **Assessment based on the 5Cs of Crédit:**

Ability to pay and intention to pay:

- Character: The customer's intensity and strength to pay.
- Capacity or ability: The customer's ability to make a successful payment.
- Capital: The amount and form of the customer's wealth that can be considered as payment insurance.
- Condition (Condition): The degree to which credit influences help or hinder demand.

- **Assessment based on financial health (LAAP méthode):**

By:

- Liquidity (Liquidity) A company's liquidity refers to the company's ability to pay its short-term obligations as they fall due.
- Activity: More sales require greater leverage either through debt or equity financing.
- Profitability: Appropriate profits that form the basis of a company's financial structure.
- Potentials: An examination of the management capacity of human and financial resources. The most important ratios adopted in the LAAP model can be summarized in the following table:

Table 01: The most important ratios used in the LAAP model

Liquidity ratios	Profitability ratios	Activity ratios
Liquidity Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$	Receivables Turnover = $\frac{\text{Sales}}{\text{Receivables}}$	Return on Assets = $\frac{\text{Net Income}}{\text{Total Assets}}$
Quick Liquidity Ratio = $\frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$	Maturity rate = $\frac{\text{Receivables} \times 360}{\text{sales}}$	Profit Margin = $\frac{\text{Net Income}}{\text{Sales}}$
Working Capital = $\text{Current Assets} - \text{Current Liabilities}$	Inventory Turnover = $\frac{\text{Sales}}{\text{Inventory}}$	Return on Equity = $\frac{\text{Net Income}}{\text{Equity}}$
	Total Assets Turnover = $\frac{\text{Sales}}{\text{Total Assets}}$	

**Source:** Sharif Misbah Abu Karsh, Bank Credit Risk Management, working paper presented to the first scientific conference on investment and finance in Palestine between development prospects and contemporary challenges, Islamic University, May 2005, p. 13.

#### ○ Evaluation based on financial analysis

**Types of financial analysis** can be divided into two parts:

- ✓ **Vertical analysis:** This means analyzing one financial statement and one financial period, and conducting the analysis on it vertically, and we mean determining the ratio of each element and item of the financial list to the total list itself, and we can also determine the ratio of each element or item of the financial list to the total group to which it belongs within the list for the same organization and for the same financial period, and we can determine the ratio of each group within the list to the total list itself. (Haitham Muhammad al-Zoubi, 2000, p. 226)
- ✓ **Horizontal analysis:** Horizontal analysis for several years includes the formulation of each element of the financial statement to be analyzed horizontally as a percentage of the value of the same element in the base year in order to determine the extent of growth, stability or decline in that element over time and this type helps to: (Shadifat, 2001, p. 119)

## 5. Conclusion

From this study, the following has been concluded:

Risk is the cause of loss, while risk is a condition that may create or increase the chance of a loss from a risk. Risk management is a management activity aimed at controlling and minimizing risks to acceptable levels and controlling them. Risk management can be categorized into financial risks (credit risk, liquidity risk, market, interest rate and exchange risk), operational risks (financial fraud and embezzlement, cybercrime, professional and legal risks), and other risks (strategic, reputational and country risks).

Bank risk management includes traditional strategies where each risk has its own management, as well as modern strategies such as securitization and comprehensive risk management, the latter of which takes several forms (capital adequacy ratio, asset-liability management, and quantitative risk management).

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