Chapter 4

Analysis and Management of Banking Risks in Commercial Banks

First: The Nature and Types of Banking Risks

1. Concept of Banking Risks: Many authors have discussed the concept of banking risks from different perspectives. Banking risks can be defined as "the adverse impact on profitability from various sources of uncertainty..

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where risks are measured under conditions of uncertainty to determine their potential negative impact on the required profitability." This adverse impact leads to losses in the bank's portfolio, and these losses can be classified into two types:

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- **Expected Loss:** Refers to risks where the bank has prior knowledge of a real and certain reason for the occurrence of losses, such as a default rate in the loan portfolio.
- **Unexpected Loss:** Refers to risks resulting from unforeseen events, such as a significant decrease in market interest rates.

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2. Types of Banking Risks: Commercial banks face various types of risks, and the type and degree of risks depend on several factors, including the size of the banking institution, the nature and scope of the activities it offers, and the complexity of those activities. **Risks based on how they are managed into three types:**

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- **Avoidable Risks:** These are risks that can be eliminated or prevented by reducing the likelihood of such losses through sound banking practices, including:

✓ Standardizing and calibrating operations and procedures to reduce incorrect decisions.

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- ✓ **Diversifying investment portfolios to reduce concentration risks.**
- ✓ **Implementing an appropriate incentive program within the bank to encourage senior management and officials to reduce risks.**

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- **Transferable Risks:** These are risks that can be eliminated or reduced by transferring them, where the burden of these risks is shifted to other parties or entities.
- **Managed Risks:** The bank's management follows a scientific approach to managing these risks, aiming to avoid or mitigate them.

First: The Nature and Types of Banking Risks

A focus can be placed on four key types of risks, representing the core risks according to the first and second pillars of the Basel Committee's guidelines, which affect the financial soundness of commercial banks through factors such as "capital adequacy and achieving targeted profitability rates." These risks are:

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- **Credit Risk:** Refers to the potential losses resulting from a customer's inability to meet their obligations on time due to general political or economic conditions, or the borrower's specific circumstances. In banking, this is referred to as default risk.

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- **Market Risk:** Refers to the current or future risks that may affect the bank's revenues and capital due to fluctuations in interest rates, exchange rates, securities prices, and commodity prices.

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- **Liquidity Risk:** Refers to the risk of losses resulting from the bank's inability to meet its obligations when they fall due. Inefficient liquidity management can lead to substantial risks, potentially causing the bank's collapse as a financial institution.

First: The Nature and Types of Banking Risks

- **Operational Risk:** Refers to risks arising from inefficiencies or failures in the bank's internal processes, people, or systems. These risks affect the accuracy and execution of banking operations and occur in daily banking activities.

Second: Factors Affecting Banking Risks

- **Increased Banking Competition:** The banking industry faces many global and local competitions, exposing it to various risks.
- **Technological Advancements:** The progress in information technology has created an urgent need for banking institutions to offer new, fast, and diverse services to a wide range of customers…

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Second: Factors Affecting Banking Risks

- **Changes in Economic Conditions:** Changes in economic conditions due to uncertainty result in expected and/or unexpected fluctuations, leading to numerous risks that affect the bank's performance and profitability.
- **Characteristics and Features of Banking Institutions:** Banking risks depend on the size of banking activities, their nature, the complexity…

Second: Factors Affecting Banking Risks

- **Regulatory and Supervisory Changes:** Regulatory and supervisory institutions impose many regulatory constraints and supervisory controls that banking institutions must comply with to reduce the risks they face. However, banks' negligence in adhering to these standards and controls exposes them to significant risks that affect their financial solvency and profitability.

Activity No. (1)

- **Activity nature:** **Discussion.**
- **Activity Time:** **5 minutes.**
- **Task:** **Discuss The Types of Banking Risk**

5 minute break.....

Tea Break

Third: Stages of Banking Risk Management

Banking risk management involves four essential stages, summarized as follows:

- **Risk Identification: The first stage of banking risk management, where the causes and drivers of risks are determined. For instance, credit default may be caused by the borrower or due to general economic conditions affecting the borrower.**

Third: Stages of Banking Risk Management

- **Risk Measurement:** Correct measurement of risks, in terms of objectivity and timing, is a key aspect of banking risk management. Each type of risk must be measured based on its three dimensions: "risk magnitude, duration of risk, and probability of occurrence

Third: Stages of Banking Risk Management

- **Risk Control or Mitigation:** There are three primary methods for controlling the risks faced by commercial banks to minimize their adverse effects:

✓ Avoiding all risk-generating banking activities.

✓ Setting maximum limits (ceilings) for risk-generating banking activities.

Third: Stages of Banking Risk Management

- ✓ **Eliminating or reducing risks when they occur.**
- ✓ **Bank management continuously monitors and controls risks, emphasizing the need to balance the returns from a particular activity with the losses caused by the associated risks.**

Third: Stages of Banking Risk Management

- **Risk Monitoring:** Bank management must establish an integrated information system capable of accurately and objectively identifying and measuring risks. Additionally, effective monitoring and supervision of changes and developments in the bank's risk profile must be activated to understand the mechanisms for addressing these risks and ensure compliance with the Basel II and III.

Presentation activity……..

- **Activity nature:** **Presentation.**
- **Activity Time:** **10: 12 minutes.**
- **Skills:** **Professional financial analysis**

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Risks in Commercial Banks