

## Factors Affecting Performance of Financial Institutions: A Case Study of Afghanistan International Bank

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### ABSTRACT

This study investigated and focused upon the risk management practices of banks in Afghanistan and their influences on banking performance. In recent years, the importance of risk management in banking institutions has grown significantly, particularly following the Global Financial Crisis. The study holds particular significance in the context of Afghanistan, a developing economy where the banking sector plays a vital role in national development. The continuity and success of banks in Afghanistan were intricately tied to effective risk management. This research aims to contribute to the ongoing debate surrounding risk management effectiveness in developing countries, specifically Afghanistan. It explores the relationship between risk management practices and banking performance while assessing the level of risk understanding and management in Afghan banks. The study's findings highlight the importance of risk understanding, risk assessment and analysis, managing credit risk, and managing liquidity risk in improving risk management practices in Afghan banks. These results provide valuable insights into enhancing the effectiveness of risk management in the banking sector.

**Keywords-** Risk management, banking performance, Afghanistan, developing economy, case study.

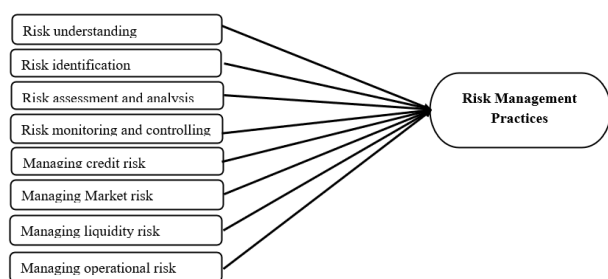
### I. INTRODUCTION

Risk management has become a central focus in the banking sector, especially since the aftermath of the Global Financial Crisis, which highlighted the critical need for effective risk mitigation strategies (Jorion, 2007). Afghanistan's banking sector has undergone significant growth in recent years, presenting both opportunities and challenges (Saunders & Cornett, 2021). This study seeks to explore the relationship between risk management practices and banking performance while assessing the degree of risk comprehension and management in Afghan financial institutions (Altman, 2018). Improved Risk Management Enhances Banking Performance: Recent studies (Altman, 2018) have shown that a strong correlation exists between the effectiveness of risk management practices and the overall performance of

banks. Banks that excel in managing risks tend to exhibited better financial stability and profitability, a critical finding in an industry where stability is paramount. This study emphasizes strategies utilized in the manufacturing sector that have proven to be more efficient than conventional approaches. Additionally, it suggests the effective incorporation of Internet of Things (IoT) technology to tackle these challenges. The research proposes the adoption of IoT technology as a holistic solution. Unlike previous studies that have typically employed JIT solely for resource utilization or TPM solely for resource management, this research promotes the individual utilization of these methods for meticulous resource planning. Lalzai, F. (2023). Identifying Vulnerabilities in Afghan Banking: Afghanistan's banking sector, as it experiences remarkable growth, is also exposed to vulnerabilities. Altman's research (2015)

can shed light on how assessing the degree of risk comprehension and management in Afghan financial institutions is vital. It helps in identifying potential weaknesses in the financial system that, if addressed, could contribute significantly to the sector's resilience. Credit Risk and Afghan Banks: Credit risk, a prominent concern for banks worldwide, is of particular importance in the Afghan context. Altman's insights (2018) can be instrumental in understanding how Afghan banks are managing credit risk, which is crucial for their long-term viability and successful lending operations. Liquidity Risk in Developing Economies: Afghanistan's developing economy presents unique challenges, including liquidity risk. Understanding how Afghan banks handle liquidity risk, as discussed by Altman (2018), can provide valuable lessons for other developing economies facing similar circumstances.

### 1.1 Conceptual Framework



**1.1.1 Risk understanding:** It should clearly understand various types of risks implemented in the bank; common understanding of the risks will lead a bank for a proper and easily identifying, controlling and assessment of different risks and establish a sense of accountability and responsibility.

**1.1.2 Risk identification:** It is very important and needed for banking to implement a comprehensive and rigorous structure of risk identification to cover all potential risks, regardless of whether or not these risks are within the direct control of banks.

**1.1.3 Risk assessment and analysis:** It is highly necessary for all the banks to implement a system for a risk assessment and analysis in order to fulfill the regulatory requirement of the central bank.

**1.1.4 Risk monitoring and controlling:** All banks should adapt a continual risks monitoring and controlling program in place, monitoring is an integral part of management activity.

**1.1.5 Managing credit risk:** Managing credit risk by the banking sector leads to reduce the level of credit risk all the information is reviewed in order to judge the borrowers' ability to repay and intentions in more efficient manners.

**1.1.6 Managing market risk:** Managing interest rate risk and foreign exchange risk enhance the level of market risk in the banking sector. The bank should have an effective risk management framework in place for managing market risk.

**1.1.7 Managing liquidity risk:** An active system of liquidity risk management is a valuable aspect of comprehensive risk management approach in banking sector, it is necessary for the management to give more consideration to deal with the liquidity risk in order to bring improvement in the risk management practices of banking sector.

**1.1.8 Managing operational risk:** Bank should an effective risk management program in place to protect unexpected external even and system failure, the management of banks regularly make investments in advanced technology to improve the effectiveness of their IT systems, in order to reduce the possibilities of system failures caused by virus attack, network failure.

### 1.2 Hypothesis

**H01:** There are no important aspects of risk management practices of banks in Afghanistan.

**H02:** There is no relationship between the risk management and performance of the banks in Afghanistan.

**H11:** There are important aspects of risk management practices of banks in Afghanistan.

**H12:** There is relationship between the risk management and performance of the banks in Afghanistan.

### 1.3 Significance of the study

In recent years, the risk management in banking institutions has got substantial importance and become centre of debate after the Global Financial Crisis. As a result, there is an increased demand for the adoption of effective risk management frameworks to ensure the continuity and success of this sector. As discussed earlier Afghanistan is a developing economy and the banking sector is playing an important role in the national development. Whereas the continuity and success of banks considerably depend upon risk management therefore, this study aims to contribute to the on-going debate of the effectiveness of the risk management in developing countries specifically in Afghanistan in following ways.

The purpose of this thesis is to study the risk management practices of banks in Afghanistan and their impact on the banking performance. In doing so, an in-depth understanding of the risk management practices is important to examine the relationship between the risk management and performance of banks. This study assesses the level of risk understanding and risk management in Afghanistan banks.

## II. LITERATURE REVIEW

The literature review encompasses various studies that explore the relationship between risk management practices and the performance of banks across different countries and regions. It highlights the significance of effective risk management in the banking sector and its impact on profitability.

Saunders (2012) emphasizes the role of existing literature in shaping research ideas and provides a

comprehensive review of risk management practices in the banking industry.

Shafique (2013) underscores the evolving nature of financial and non-financial risks in banking and the imperative for banks to efficiently manage these risks.

Kao et al. (2011) stress the importance of understanding different types of risks and the need for banks to accept only those risks that align with their array of services.

Anderson (2010) examines the risk management system and its relevance to UAE banks, with a focus on risk mitigation techniques used by these banks.

Shafiq and Nasr (2010) shed light on the critical types of risks in Pakistani banks and the common understanding of risk among bank staff.

Alam and Maskujaman (2011) investigate risk management practices in Bangladeshi commercial banks, highlighting credit risk, market risk, and operational risk as major concerns.

Hassan (2011) conducts a comparative study of risk management practices in Islamic and conventional banks across the Middle East and emphasizes the importance of a uniform risk management framework.

Abu Hussain and Al-Ajmi (2012) report on risk management practices in Bahraini conventional and Islamic banks, highlighting the importance of understanding risk and effective risk management.

Khalid and Amjad (2012) examine risk management practices in Pakistani Islamic banks, focusing on risk identification, assessment, and analysis.

Nazir, Daniel, and Nawaz (2012) conduct a comparative study of risk management practices in Afghanistan's conventional and Islamic banks, emphasizing risk understanding and risk monitoring.

Bilal, Talib, and Khan (2013) investigate risk management practices in emerging economy banks, particularly focusing on risk measurement and Basel III compliance.

Selma, Abdelghani, and Rajhi (2013) explore risk management practices in Tunisian banks, highlighting the role of risk identification and risk assessment.

Hassan (2013) conducts a comparative study of risk management practices in Islamic and conventional financial institutions in Pakistan, finding common understanding and effective risk management practices.

Wood and Kellman (2013) study the risk management practices of Barbadian banks and their focus on credit risk, operational risk, and other risk types.

Ariffin and Kassim (2011) analyze the relationship between risk management practices and the financial performance of Islamic banks in Malaysia, emphasizing a strong positive relationship.

Oluwafemi et al. (2013) find a significant relationship between risk management and the performance of Nigerian banks, particularly in managing the cost of bad and doubtful loans.

Fernando and Nimal (2014) investigate the impact of risk management on the efficiency of banks in Sri Lanka, with a focus on technical efficiency.

Chang and Lee (2010) examine the impact of banking system reforms on the productivity of Korean banks, observing changes in efficiency during financial crises.

Karim, Chan, and Hassan (2010) study the relationship between non-performing loans and bank efficiency in Malaysia and Singapore, finding a negative relationship.

Ariffin (2012) explores liquidity risk and its impact on the financial performance of Islamic banks in Malaysia, highlighting the importance of effective risk management and transparency.

Schmid (2012) investigates the impact of risk management-related corporate governance on bank performance during the financial crisis of 2007-2008.

Musyoki and Kadubo (2012) assess the parameters relevant to credit risk management and their effects on the financial performance of banks in Kenya.

Afriyie and Akotey (2013) examine the risk management and profitability of rural banks in Ghana, with a specific focus on credit risk.

Al-Khouri (2011) investigates the impact of different risk factors on the performance of commercial banks in Gulf Cooperation Countries (GCC).

Poudel (2012) studies the impact of credit risk management parameters on the financial performance of banks in Nepal.

Maghyereh and Awartani (2014) analyze the impact of market power, risk-taking activities, and regulations on the performance of the banking sector in Gulf Cooperation Countries (GCC).

### III. METHODOLOGY

This chapter outlines the research method employed, including research design, population, sample size, data collection, and sources. The study examines risk management practices in Afghan banks, incorporating data from various local banks, including the central bank of Afghanistan, obtained through a questionnaire (Appendix A) and analyzed using SPSS for descriptive statistics.

**3.1 Research Design:** This research employs a case study design with a deductive approach to analyze risk management in Afghanistan's local banks. Descriptive research aims to provide a detailed understanding and fill knowledge gaps.

**3.2 Pre-testing:** A pilot study with 12 employees from Afghan local banks assessed the research instrument's internal validity. The positive results confirmed the instrument's reliability for the main study.

**3.3 Survey Instrument Reliability:** The survey instrument underwent reliability analysis, including Cronbach's alpha. The alpha value for all study variables surpassed

the recommended threshold of 0.6. Specific alpha values for each study variable are detailed in Exhibit-1.

Exhibit-1: Details of Cronbach Alpha values for Risk Management Practices Dimensions		
Cronbach's Alpha	Cronbach's Alpha based on Standardized Items	No of items
0.891	0.806	96

**3.4 Population:** The study focused on employees of local banks, including the central bank, due to its case study design. Out of the 200 employees in risk management departments, 96 were selected to provide comprehensive insights. Similar findings of the reliability statistics were there in the Stanikizai, A. J. (2023)

**3.5 Sampling Size:** Ninety-six employees from local banks' risk management directorates, including the central bank in Afghanistan, were selected for the study.

**Source of Data:** The study collected both primary and secondary data.

**3.6 Primary Data Collection:** Primary data was obtained through questionnaires from management, senior staff, and junior staff in the risk management directorates of local banks in Afghanistan, analyzing risk management in the banking sector.

**3.7 Secondary Data Collection:** Secondary data was gathered from various sources, including articles, publications from the central bank of Afghanistan, textbooks, journals, newspapers, the internet, and other writings.

**3.8 Data Analysis:** Data analysis was performed using the Statistical Package for Social Science (SPSS). Data processing included editing, coding, and tabulation. Formal permission was obtained from department heads, and 96 completed questionnaires were collected. Data was entered into the latest version of SPSS for analysis (Lalzai, F., 2023).

## IV. RESULT AND DISCUSSION

Table 1: Shows distribution of respondents' gender wise					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Male	72	75.0	75.0	75.0
	Female	24	25.0	25.0	100.0
	Total	96	100.0	100.0	

Source: Primary Data

Table 1 indicated that gender wise distribution of the respondents. Gender of the respondents has been classified into two sub-categories i.e. Male and Female. The result reveals that out of total 96 respondents, 72

respondents i.e. 75 % are male and 25 respondents i.e. 25 % are female.

Hence, it is concluded from the results of the above table that majority of the respondents belongs to male category of gender.

Table 2: The bank has an effective risk management framework (infrastructure, process and policies) in place for managing market risk					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Not Sure	24	25.0	25.0	25.0
	Agree	48	50.0	50.0	75.0
	Strongly Agree	24	25.0	25.0	100.0
	Total	96	100	100	

Table 2 showed that from 100% of the respondents. 24 respondents i.e. 25 % are Not Sure and 48 respondents i.e. 50% are Agree and 24 respondents i.e. 25 % are Strongly Agree that the bank has an effective risk management framework (infrastructure, process and policies) in place for managing market risk.

More ever results reveal that highest numbers of respondents i.e. 50 % are strongly agree with the bank has an effective risk management framework (infrastructure, process and policies) in place for managing market risk and lowest number of respondents i.e. 25 % not sure with the bank has an effective risk management framework (infrastructure, process and policies) in place for managing market risk.

Table 3: The bank adopts multiple risk measurement methodologies to capture market risk in various business activities					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Not Sure	24	25.0	25.0	25.0
	Agree	48	50.0	50.0	75.0
	Strongly Agree	24	25.0	25.0	100.0
	Total	96	100	100	

Table 3 revealed that from 100% of the respondents. 24 respondents i.e. 25 % are Not Sure and 48 respondents i.e. 50% are Agree and 24 respondents i.e. 25 % are Strongly Agree that the bank adopts multiple risk measurement methodologies to capture market risk in various business activities. More ever results reveal that highest numbers of respondents i.e. 50 % are agree with the bank adopts multiple risk measurement methodologies to capture market risk in various business



activities and lowest number of respondents i.e. 25 % not sure with the bank adopts multiple risk measurement methodologies to capture market risk in various business activities.

**Table 4: The bank regularly prepares periodic report of market risk**

		Frequency	Percentage	Valid Percentage	Cumulative Percentage
Valid	Not Sure	24	25.0	25.0	25.0
	Agree	48	50.0	50.0	75.0
	Strongly Agree	24	25.0	25.0	100.0
	Total	96	100	100	

Table 4 depicted that from 100% of the respondents. 24 respondents i.e. 25 % are Not Sure and 48 respondents i.e. 50% are Agree and 24 respondents i.e. 25 % are Strongly Agree that the bank regularly prepares periodic report of market risk.

More ever results reveal that highest numbers of respondents i.e. 50 % are agree with the bank regularly prepares periodic report of market risk and lowest number of respondents i.e. 25 % not sure with the bank regularly prepares periodic report of market risk.

**Table 5: There is a proper set of rules and guidelines, for managing liquidity risk, available in the bank**

		Frequency	Percentage	Valid Percentage	Cumulative Percentage
Valid	Not Sure	24	25.0	25.0	25.0
	Agree	48	50.0	50.0	75.0
	Strongly Agree	24	25.0	25.0	100.0
	Total	96	100	100	

Table 5 revealed that from 100% of the respondents. 24 respondents i.e. 25 % are Not Sure and 48 respondents i.e. 50% are Agree and 24 respondents i.e. 25 % are Strongly Agree that there is a proper set of rules and guidelines, for managing liquidity risk, available in the bank.

More ever results reveal that highest numbers of respondents i.e. 50 % are agree with there is a proper set of rules and guidelines, for managing liquidity risk, available in the bank risk and lowest number of respondents i.e. 25 % not sure and strongly agree with there is a proper set of rules and guidelines, for ma.

**Table 6: Results of the regression for hypothesis-1**

Model	Unstandardized Coefficients		Standardized Coefficients	T	F	Sig.
	B	Std. Error	Beta			
(Constant)	0.626	0.880		0.712	31.275*	.041
Risk understanding	0.329	0.058	0.308	5.717*		.000
Risk identification	1.043	0.084	1.091	12.414*		.000
Risk assessment and analysis	0.037	0.088	0.033	0.421*		.031
Risk monitoring and controlling	0.031	0.063	0.039	0.492		.624
Managing credit risk	0.007	0.045	0.008	0.158*		.001
Managing Market risk	0.016	0.104	0.015	0.154		.878
Managing liquidity risk	0.003	0.062	0.004	0.042*		.002
Managing operational risk	0.494	0.078	0.502	6.357*		.000

Dependent Variable: Risk management practices; \* significant at 5 percent level;  
Source: Computed from primary sources

Table 6 showed that the 't' value of 5.717 obtained for risk understanding significantly causes considerable effect on the bank's performance. This confirms the negative effect of risk understanding on risk management practices, such as There is a common understanding of risk management across the bank, there is a proper system for understanding various risks implemented in the bank, responsibility for risk management is clearly set out and understood throughout the bank, accountability for risk management is clearly set out and understood throughout the bank.

The risk assessment and analysis with 't' value of 0.421 also causes significant substantial effect on risk

management practices. This confirms the positive effect of risk assessment and analysis such as the bank assesses the likelihood of occurring risks, the bank's risks are assessed by using quantitative analysis methods, the bank's risks are assessed by using qualitative analysis methods (e.g. high, moderate and low), the bank analyses and evaluates opportunities it has to achieve objectives, the bank's response to analyzed risks includes an assessment of the costs and benefits of addressing risks, the bank's response to analyzed risks includes prioritizing of risks and selecting those that need active management, the bank's response to analyzed risks includes prioritizing risk treatments where there are resource constraints on risk treatment implementation, the bank undertakes a credit worthiness analysis before granting credit or executing transactions, before granting capital or credit by bank undertakes specific analysis including the applicant's character, capacity, collateral and conditions, the bank has a computer based support system to estimate the earnings and risk management variability, and The bank relies on the output of quantitative data with human judgment.

The managing credit risk with 't' value of 0.158 also causes significant substantial effect on risk management practices. This confirms the positive effect of managing credit risk such as the credit risk strategy set by the board of directors are effectively transformed and communicated within the bank in the shape of policies and procedures by the top management, the bank has an

effective risk management framework (infrastructure, process and policies) in place for managing credit risk, the bank has a credit risk rating framework across all type of credit activities, the bank monitors quality of the credit portfolio on day-to-day basis and takes remedial measures as and when any deterioration occurs, and the bank regularly prepares periodic report of credit risk.

The managing liquidity risk with 't' value of 0.042 also causes significant substantial effect on risk management practices. This confirms the positive effect of managing liquidity risk such as there is a proper set of rules and guidelines, for managing liquidity risk, available in the bank, the liquidity risk strategy set by the board of directors are effectively transformed and communicated within the bank in the shape of policies and procedures by the top management, the bank has an effective risk management framework (infrastructure, process and polices) in place for managing liquidity risk, the bank regularly prepares periodic report of liquidity risk, and applications of liquidity risk management techniques reduce cost of expected losses.

The remaining 't' value of 0.492 and 0.154 corresponding to the dimension of risk management practice such as risk monitoring and controlling and managing market risk are not found to be significant at 5 percent level as well. Hence, it can be inferred that banks performance depend significantly on these risk management practices.

**Table- Results of the correlation for hypothesis-2**

**Table 7: Correlations between risk management practices**

		Risk understanding	Risk identification	Risk assessment and analysis	Risk monitoring and controlling	Managing credit risk	Managing Market risk	Managing liquidity risk	Managing operational risk
<b>Risk understanding</b>	Pearson Correlation	1							
	Sig. (2-tailed)								
	N	96							
<b>Risk identification</b>	Pearson Correlation	.352**	1						
	Sig. (2-tailed)	.000							
	N	96	96						
<b>Risk assessment and analysis</b>	Pearson Correlation	.271**	.737**	1					
	Sig. (2-tailed)	.008	.000						
	N	96	96	96					
<b>Risk monitoring and controlling</b>	Pearson Correlation	.167	.353**	.319**	1				
	Sig. (2-tailed)	.104	.000	.002					
	N	96	96	96	96				

<b>Managing credit risk</b>	Pearson Correlation	.248*	.683**	.585**	.295**	1			
	Sig. (2-tailed)	.015	.000	.000	.003				
	N	96	96	96	96	96			
<b>Managing Market risk</b>	Pearson Correlation	.257*	.803**	.861**	.392**	.628**	1		
	Sig. (2-tailed)	.012	.000	.000	.000	.000			
	N	96	96	96	96	96	96		
<b>Managing liquidity risk</b>	Pearson Correlation	.208*	.516**	.513**	.865**	.518**	.522**	1	
	Sig. (2-tailed)	.042	.000	.000	.000	.000	.000		
	N	96	96	96	96	96	96	96	
<b>Managing operational risk</b>	Pearson Correlation	.709**	.697**	.517**	.258*	.449**	.433**	.325**	1
	Sig. (2-tailed)	.000	.000	.000	.011	.000	.000	.001	
	N	96	96	96	96	96	96	96	96
<b>** Correlation is significant at the 0.01 level (2-tailed).</b>									

Table 7 discriminated that the possibility of 8 risk management practices dimensions such as Risk Understanding, Risk Identification, Risk Assessment and Analysis, Risk Monitoring and Controlling, Managing credit Risk, Managing Market Risk, Managing Liquidity Risk, and Managing Operational Risk with each other is defined in hypothesis-2 taken up and its results are shown in the table-64, as an outcome of Bivariate Correlation test. From the results it can be inferred that Pearson 'r' values between the range 0.208 and 0.865 corresponding to 27 different correlations are found to be significant at 1 and 5 percent level. However, the Pearson 'r' value of 0.167 corresponding to 27 different correlations is not found to be significant at 1 and 5 percent level. All these insignificant correlations have risk management practices dimension risk monitoring and controlling as the correlating dimension. While these results form the basis to reject the hypothesis-2, the importance of 27 significant correlations among the total of 28 possibilities gives scope for identifying the different levels of relationship that can exist with risk management practices dimensions.

## V. CONCLUSION

In conclusion, this study has delved into the risk management practices and their impact on the performance of handpicked banks in Afghanistan. The findings underscore the pivotal factors underpinning an effective risk management framework within Afghan banks. Foremost among these factors is the imperative understanding of risk and risk management among the bank's personnel. Moreover, it is paramount for these banks to institute a proactive risk management process encompassing the identification, measurement, monitoring, and control of a spectrum of risks, including credit, market, liquidity, and operational, coupled with the allocation of adequate capital to mitigate these risks.

Conforming to the guidelines set forth by Da Afghanistan Bank, the implementation of a comprehensive risk management system not only serves regulatory compliance but also proves to be a highly effective practice in enhancing the performance of banking institutions. As demonstrated by the research findings, risk management undeniably plays a significant role in shaping the performance of the selected banks in Afghanistan.

### Recommendations

- Establishing a robust liquidity risk management framework is crucial for banks.
- Banks should regularly disclose their liquidity information to provide transparency and enable market participants to assess their liquidity risk management and position.
- To enhance risk management, banks, including central banks and state-owned banks, must implement comprehensive policies and procedures, ensuring a clear understanding of various risks for improved risk identification and measurement.

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