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Ensuring Financial Stability Through Effective Organization of Risk Management in Commercial Banks

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Abstract: This article discusses the economic nature of risks in commercial banks, the reasons for their emergence, and their consequences. It presents the views of economists on the economic content of risks in commercial banks. The types of banking risks and the organizational structure of their management are elaborated. Proposals for improving the risk management mechanism in commercial banks have been developed.

Keywords: Commercial banks, risks, currency, credit, interest rate, investment, securities, national economy, financial instruments.

Introduction: In the context of modern market relations, commercial banks occupy a significant position as leading components of the economy and play a crucial role in implementing the state's monetary and credit policies. By regulating the movement of capital flows, commercial banks contribute to the effective use of financial resources in society.

It is well known that commercial banks operate under high-risk conditions. Typically, banks exposed to high levels of risk are believed to have the potential to generate higher profits. Evaluating the performance of commercial banks is one of the complex tasks. Effective risk management is essential for ensuring the long-term success and stability of a bank.

It should be noted that in recent years, numerous reforms have been implemented in the banking practice of our country to improve the scientific and practical aspects of risk management in commercial banks. This has led to the development of specific mechanisms for managing risks in commercial banks.

In particular, the "Development Strategy of New Uzbekistan for 2022–2026" identifies ensuring financial stability in the banking system as a priority task. With the support of the International Monetary Fund, practical measures are being taken to develop stress test models aimed at identifying potential threats in the economy and assessing their impact on the stability of the banking system. Accordingly, the Central Bank of the Republic of Uzbekistan adopted Resolution No. 4/11 on March 7, 2023, which approved the "Regulations on Requirements for the Risk Management System of Banks and Banking Groups."

This Regulation outlines the requirements for the risk management systems of banks and banking groups. Clearly, the development of risk management mechanisms in commercial banks based on international best practices is among the urgent issues.

Commercial banks use various tools and methods to manage risks, including risk assessment, risk mitigation strategies, risk monitoring, and reporting. By identifying potential risks and implementing appropriate controls, commercial banks can reduce the likelihood of adverse events affecting their financial operations.

Poor risk management can result in financial losses, reputational damage, regulatory sanctions, and even bank failure. Therefore, it is essential for commercial banks to have robust risk management systems in place to protect stakeholders and ensure their ongoing success.

LITERATURE REVIEW

Numerous studies by domestic and foreign economists have been conducted on risk management in commercial banks. These studies cover the economic essence of financial risks, the reasons for their occurrence, and their impact on the financial stability of commercial banks.

The growing uncertainty of the economic environment has increased the relevance of risk management in the banking sector. Although the role of banks in national development is growing, these financial institutions are increasingly exposed to various risks. Risk management is considered a key factor determining the success or failure of any financial institution.

Liberalization, globalization, and rapid technological advancement have created new business opportunities but have also led to more complex and diverse risks compared to the past. Identifying, evaluating, and controlling risks have never been more critical in corporate and strategic management.

Financial risks—particularly for companies listed on stock exchanges whose value depends on market conditions—remain one of the major issues faced by companies. The main types of risks common to all companies include liquidity, credit, market, and other non-financial risks.

Financial risks for commercial banks typically involve unexpected changes or fluctuations in profit. According to international practice, there are many types of financial risks in banking, all of which negatively impact the bank's financial performance.

The term "financial risk" is a general concept that includes various risks related to financing, including financial operations associated with corporate default risks. These risks mainly arise from the volatility of assets and the potential decline in the stock market, often linked to debt obligations and imbalances between current assets and liabilities.

The impact of credit risks in commercial banks exceeds that of other types of risks. This is due to the high proportion of loans in the total assets of commercial banks; the non-repayment of issued loans reduces bank liquidity; and the untimely and incomplete repayment of loans leads to a decrease in interest income, which negatively affects the financial stability of banks.

The risk management strategy should align with the company's development strategy. It should support the company's mission and vision and reflect its core values and risk appetite. If not, banks may fail to achieve their mission and vision. A misaligned strategy increases risk for stakeholders as it may impact the company's value and reputation.

To evaluate and reduce the impact of risks on bank income, it is essential to classify risks based on different criteria. Systematizing risks based on characteristics and indicators, and grouping them into common categories, depends on the motivation of the subject managing the risk.

In our opinion, managing financial risks in banks is a complex activity associated with the multifaceted nature and manifestation of financial risks, which often have diverse and even contradictory foundations.

The above definitions by economists indicate that financial risks in commercial banking are objective realities, with more types of risks found here than in other financial institutions. One of the main tasks in managing financial risks in commercial banks is to analyze the causes and factors of risks systematically and to develop measures aimed at minimizing their effects.

RESEARCH METHODOLOGY

During the scientific research, logical and structural analysis, mutual and comparative comparison, generalization, grouping, abstract-logical thinking, and prospective forecasting methods were effectively used.

ANALYSIS AND RESULTS

The financial stability and long-term success of commercial banks directly depend on the effective risk management system. To ensure effective management of banking risks, it is appropriate to identify the factors influencing risks.

Generally, risks can be divided into external and internal types based on their sources. The risk management process includes the development of strategy and tactics. The strategy aims to identify ways to achieve set goals and involves long-term forecasting and strategic planning of risks.

When selecting a risk management strategy, it is necessary to ensure the continuity of bank operations and strike an optimal balance between the level of risk taken and profitability. Based on the strategy, a risk management tactic is developed, including specific methods and tools to achieve the defined goals.

The main goal of developing risk management tactics in banks is to select the most optimal decisions without contradicting the strategy, and to apply the most effective management methods under current conditions to reduce the level of risk.

There are various types of risks in commercial banks, each differing in terms of management and approach (Table 1).

Table 1

Types of Risks in Commercial Banks and Their Management Strategies

Risk type	Description	Potential consequences	Detection method	Management strategy
Credit risk	Non-fulfillment of credit obligations by borrowers	Loss of assets, reduced interest income	Credit rating, analytical modeling	Credit scoring, underwriting, portfolio diversification
Liquidity risk	The risk of the bank's inability to meet its short-term obligations	Loss of investor and customer confidence in the bank, penalties	Liquidity indicators, stress tests	Cash flow planning, maintaining the level of liquid assets
Market risk	Changes in interest rates, exchange rates, or prices of financial assets	Reduced net profit, loss of capital	VAR, sensitivity analysis	Hedging, setting limits
Operational risk	Errors in internal corporate governance processes, personnel, or systems	Fines, damage to image	Audit, security monitoring	Standard operations, technological security
Legal and compliance risk	Non-compliance with legal requirements	Fines, license revocation	Compliance control, audit	Improving the activities of the legal department, organizing additional training seminars for employees
Strategic risk	Incorrect choice of bank strategy	Reduced market share, lost opportunities	SWOT analysis, market monitoring	Strategic planning, competitiveness analysis

It is essential to take into account all classification aspects of risks when managing financial risks. For example, credit risk is one of the most common types of risks in banking operations, and its management requires a systematic assessment of borrowers' financial standing, stability, and credit history. At the same time, liquidity risk reflects a bank's ability to meet its obligations in a timely manner. To prevent this risk, banks must pay special attention to reserve policy and contingency planning. Market risk arises due to global and national economic factors, and to mitigate this type of risk, banks extensively use derivative instruments and hedging practices.

Operational risks are especially relevant in the current context of growing digital banking services and can be addressed by strengthening technological security and internal control mechanisms. Legal and strategic risks, on the other hand, are among the factors that affect the long-term sustainable development of banking activities. To prevent such risks, it is necessary to conduct market monitoring, competitor analysis, and strategic planning.

In risk management systems, it is advisable to distinguish three main stages: risk analysis (identification and assessment), risk control (monitoring), and risk mitigation (neutralization).

During the risk analysis stage, processes of identifying and assessing risks are carried out. At this stage, the factors influencing the risk level are identified, along with the circumstances that increase or decrease the likelihood of risks arising during the execution of certain banking operations. The next stage is risk control, which includes measures aimed at reducing or completely eliminating the level of risk. There are three main methods of risk control: through internal audit, external audit, and internal control systems.

There are also three main methods of risk mitigation:

1. Risk avoidance – a conservative approach in which a bank refrains from engaging in activities involving unacceptable levels of risk. This may mean forgoing potential profits in exchange for safety.

2. Risk reduction – usually achieved through self-insurance (creating reserves), diversification, setting limits, and minimizing exposure.

3. Risk transfer to a third party – typically implemented through insurance, hedging, or risk-sharing mechanisms.

The risk management system in banks is an integrated framework composed of interrelated elements that regulate the development and implementation of management decisions in risky situations. Through these elements, banks carry out effective risk analysis, evaluation, and management, as well as optimize socio-risk relations, thus ensuring the stability of the financial system.

A well-functioning risk management system in banks contributes to achieving strategic goals, improving the efficiency of banking services, supporting sustainable and intensive growth, economic independence, and competitiveness. It is important to emphasize that risk management requires a tailored approach for each bank, with careful consideration of the specific causes of risks. This process is unique and depends on factors such as the bank's scale of operations, level of development, socio-economic potential, internal corporate governance system, counterparties, clients, characteristics of competitors, strategies, risk levels, and other relevant factors.

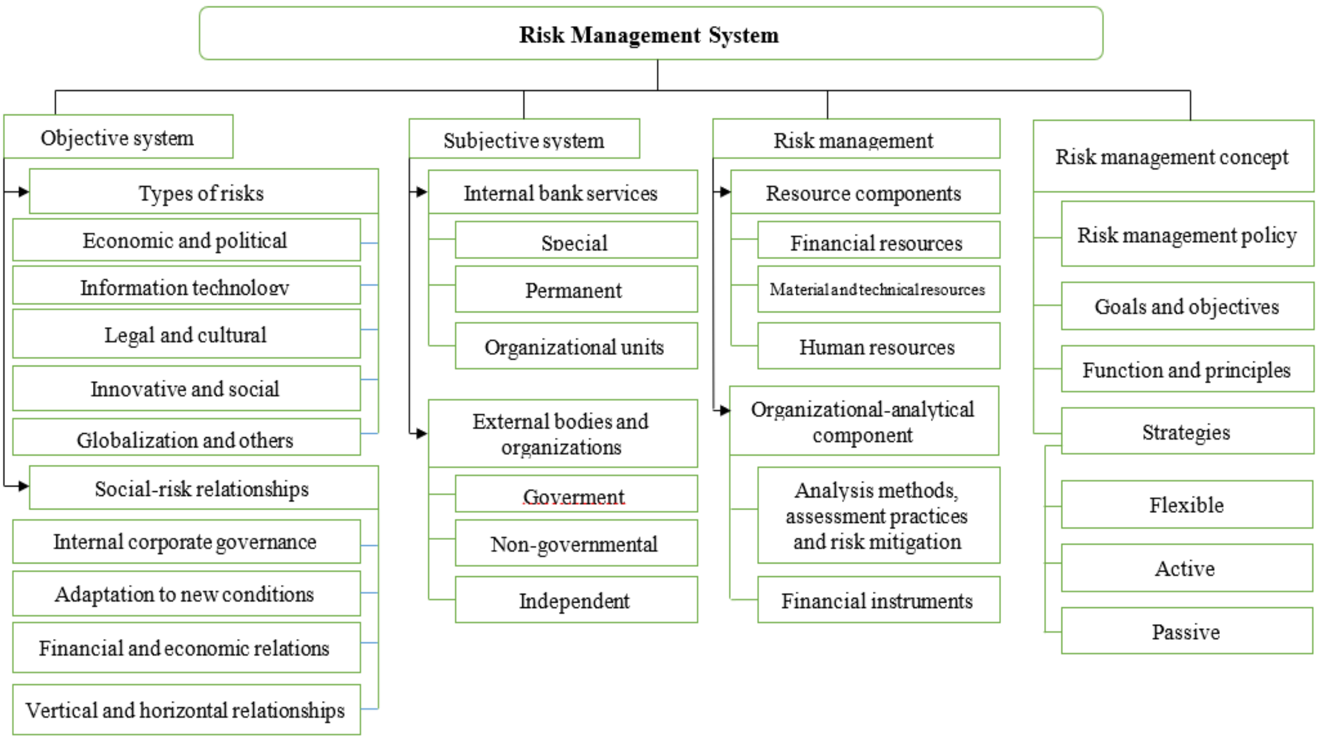

Figure 1. Organizational Structure of the Risk Management System in Commercial Banks

Therefore, each commercial bank must develop a risk management system tailored to its internal and external environment.

It is advisable to identify the general characteristics of such a system during this process. Although the risk management system is integrated into the overall management structure of a bank, it should operate independently of the bank's executive bodies and other administrative units in the decision-making process. Risk management is a complex and multi-level mechanism aimed at maintaining an optimal level of total risk exposure through effective risk mitigation and the establishment of a robust internal corporate governance structure.

The risk management system consists of four main subsystems: the objective (controllable) subsystem, the subjective (controlling) subsystem, the functional risk management mechanism, and the risk management concept. Each subsystem in turn includes several interrelated components (see Figure 1).

According to the diagram, all elements within the management system form an integrated complex for managing risks in commercial banks. These subsystems are interconnected and play a crucial role in shaping the bank’s risk management policy.

Generally, a risk management policy encompasses the bank’s fundamental directions, principles, and actions for identifying, assessing, monitoring, and mitigating risks.

Another critical aspect of financial risk management is continuous risk monitoring and control. The primary purpose of monitoring is to consistently observe risk situations, ensure operations remain within predetermined parameters (constraints and limits), and respond promptly to any deviations.

CONCLUSION

The rapidly changing market conditions of banking activities, the plans to implement the Basel Committee principles in Uzbekistan's banking practices, and the expansion of digital banking services necessitate the further development of risk management systems in commercial banks.

In our view, risk in commercial banking refers to the uncertainty associated with future cash flows, the likelihood of losses, reduced profits compared to projections, or unanticipated expenses arising during the execution of banking operations.

Therefore, effective risk management and timely decision-making regarding risk reduction are among the most vital objectives for any financial institution. In practice, a change in one type of risk often triggers the emergence or amplification of other financial risks. This situation requires selecting appropriate risk analysis methods and developing preventive measures accordingly. Hence, assessing the current risk level and identifying optimal influencing factors constitute essential stages in the risk management process. International best practices show that quantitative analysis methods are widely employed in financial risk assessment.

These methods consider both external risk factors and internal elements related to corporate governance. As a result, the outcomes significantly contribute to the accuracy and reliability of forecasts developed by commercial banks. The bank's risk management strategy should be closely aligned with the overall strategy for managing assets and liabilities. Among the various risk categories, market risk is considered one of the most complex. It includes interest rate, currency, and capital market risks. The effectiveness of market risk management largely depends on the models and assessment methods employed. Unfortunately, one of the primary issues facing many commercial banks today is the underdeveloped nature of their risk assessment methodologies.

It is important to highlight that managing market risk is a key condition for ensuring the financial stability of commercial banks. To achieve this, it is essential to develop models tailored to national conditions, implement risk assessment practices at every operational level, improve national legislation in line with international standards, and modernize internal corporate governance systems both scientifically and methodologically.

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