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# BANKING RISK MANAGEMENT OF KOSOVO'S COMMERCIAL BANKS

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**Abstract**:

Risk management is one of the processes and main strategies used by companies. Through better risk management can be avoid the negative outcomes and be ensured the company's success in the area it operates. This strategy can be achieved through the use of appropriate methodologies and processes. Commercial banks in Kosovo are being followed and implemented this strategy and therefore they invest on new developments and innovations.

The object of this study is investigation of banking risk management of commercial banks in Kosovo. For elaboration of this theme is designed a questionnaire through which are received financial and operational data from six commercial banks operating in Kosovo. During the research process are applied qualitative and quantitative methods, especially statistical analysis. Regarding the findings of the research revealed almost everything that is stated in the literature review and analysis of the concept of risk management around secondary data which already exist.

**Key Words**: Risk management, commercial banks, banking risk, banking sector, financial system.

## Introduction

Risk management started to be applied in the early of 1800's, where banks have recognized the importance and role of risk management and adaptation were the same, creating a feature in their organizations in order to control the risks that

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arise in business and bank operations.

Risk management in banking sector anywhere in the world is in the spotlight especially after the recent crisis of 2008, which has had a major impact on the existence of the banking sector as a sustainable industry. Where the main consequences were unpaid loans, deposits with high interest rates, limited income, loss of trust in banks.

According to scientific research, it shows that the policy and practice of risk management in the banking system is a combination of processes and models that are applied by them. Banks are not traditional financial intermediation practice in low-risk environment. But, are involved with a wide range of new evolutions of financial products, where risk management today represents a dynamic and active risk management assets and liabilities in a changing environment and high risk.

Currently, banks are using complex systems and techniques of management tools to measure, monitor and control risks, which are mainly categorized in credit risk, market risk, interest rate risk, liquidity risk, operational risk and legal risk. In fact, risk refers to any uncertainty that could result in a loss, while on the other hand a good management enables increased profit and return on portfolio of banks.

Progress reached in this area has deals with the identification of new risks, assessing their quantitative and protective measures for all the above categories of risks, relying on more accurate indicators.

The main purpose of this study is to research the level reached of the risk management process by commercial banks in Kosovo, following all phases of risk management as the identification, analysis, evaluation and monitoring as well as structures built by the commercial banks.

In this paper besides theoretical treatment on the conception of risk management, is made a quantitative research (quantitative) that develops the process of risk management in commercial banks in Kosovo.


**Conception of Risk Management**

Numerous authors from different countries have conducted empirical studies relating the management of risk in commercial bank. Studies such as Treacy and Carey (1998) in the U. S. , Gray (1998) in Australia, Anbar (2005) in Turkey, Parrenas (2003) for Asian banks, Shafakli (2007) in North Cyprus, and Mohammad Hussein (2007) the United Arab Emirates, have provided empirical evidence of risk management practices in their research.

Studies by Indian authors: Rajaraman and Vasistha (2002), and BhaumikPiesse (2003), Sathya (2005), and Chaudhari and Sensarma (2008), focused

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on issues related to probability, non-performing banking operations, the impact of privatization and risk management policies. Their findings revealed that banks had greater and more profitable technology and better management of risk.

In a recent study, Mehra (2010) examined the impact of ownership and size over a range of operational practices of risk management in Indian banks. The study concluded that large banks have had a well-developed framework for operational risk models and also was observed that the size of banks can be a hindrance for: data collection, tracking of external influences, identification of the level of involvement and impact of operational risk and comprehensive analysis.

**Risk management and its function -Perception and attitude to risk management**

Risk management is a systematic process that identifies, analyzes, monitors, controls and communicates risks associated with any business activity, in order to avoid risk, minimize losses and maximize profits.

According to IAA90risk is defined as uncertainty about a possible event to happen in the future which will have an impact in achieving the objectives of the company, while risk from the organizational aspect is seen as anything which could have an impact on the achievement of objectives of the organization or corporation. Organizations do not always realize the objectives set forth in its plans, so it is very important given the importance of risk management risks recognized, treated and possibly eliminate all those risks that impede the realization of its objectives (COSO).

Admission and financial risk management for the businesses in the banking sector is a natural action, which represents the central part within the particular discipline of strategic management of each bank. Risk management process includes all activities and portfolio of commercial banks, which also affect the structure profiling for risk management.

**Philosophical and operational access of risk management**

According Angelopoulos and Mourdoukoutas (2001), there are two different ways to approach risk management: the philosophical and operational.

a) Philosophical approach deals with the return of risk that exists a relation between risk and profit that create different options for decision makers towards risk.

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In accordance with the magnitude of risk from philosophical approach there are three categories of persons (Dhuci 2001, p 20) towards the behavior of risk:

a. Persons with risk-neutral behavior
b. Persons that love risk
c. Persons non-prone to risk

Profiles that characterize transactions and portfolios are the centerpiece of the whole system where must be ensured all necessary measures and models that match with business lines on the global level.

Attitudes of decision-makers towards risks that create different strategies in terms of risk management in the banking system should be ready to organize and manage risk accordingly with the strategically circumstances that are shaped.

The period of crisis that exists in the recent period has led bankers to opt non-prone attitude to risk in terms of liquidity, especially to credit risk.

b) Operational approach deals with the identification and classification of banking risks in order to take measures and decisions understandable and stable.

Identification and summary of all the risks of a business is a big issue for successful leadership, especially after the evolution of organizations that are not involved in managing the daily operations of the business but are dependent on the formal reporting mechanisms (Kimball1997, p. 24).

It should be emphasized that these two approaches are directly related and are a necessity for the design of an effective strategy of risk management.

## 3. 3. The importance of risk management

Risk management is an essential element of corporate governance necessary for balancing risk and reward, opportunities and threats as well as strategies and operations.

Sustainable management of risk is the most perfect of risk management and banking industry, which has led to the creation of sustainable institutions in the strategic as well as in the operational aspectand thus creating investor confidence and safety of customers for commercial banks.

Commercialbanks, regarding theiroperationalrisk managementthroughinternal controlhavecreatedreasonableeconomicvalueand commercial. Thanks tothe rise ofinternal control, commercialbankshave been able toprotect themselvesfromnegativeriskactivities. The importanceofrisk

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managementliesinthe level of functioningofthe internal controlasthe mostefficienttoolforprotectionagainstlarge lossesandcontingencies.

The fact that business activities anywhere in the world, today are held by a direct interdependence of the financial system, of which act as multinational organizations, it is necessary that these multinational financial organizations manage risk, in order to create sustainable financial stability not only for the organization but also for the entire system. Specifically, internal controls do a serious job to protect the bank from credit risk, liquidity, operational and legal risks. Moreover, risk management protects and adds value to the bank.

### Risk management model as a process

Risk management is a continuous process which occurs throughout the life cycle of a system. This is an organized methodology to identify and measure the unknown, making the development of options, selection, planning, implementation and appropriate risk mitigation measures in order to ensure the reduction of risk successfully. Model which is mostly used by financial organizations is created by AIRMIC, ALARM, IRM (AAIRM) standard including the following areas: risk management, risk assessment, risk analysis, evolution of risk, risk reporting, treatment risk, risk monitoring and review of risk management as a process, structure and management of risk management.

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Figure 2: The model of Risk Management
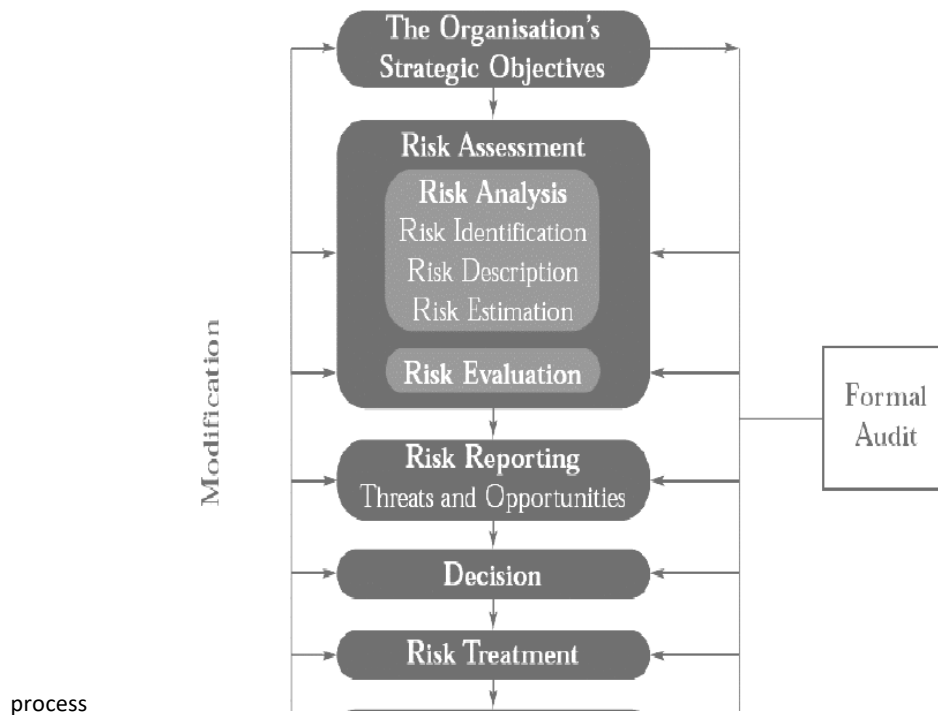


process

**Source:** AIRMIC, ALARM, IRM: 2002

This risk management model represents all the factors that are necessary for effective and successful management of risk. Although the figure above are presented simpler procedures and basic risk management process is different across banks due to different risk profiles of banks adopt. So it is important to set the strategic objectives of the bank that best suit its risk profiles.

Analysis ofrisk assessment(ISO /IECGuide73) beginswiththe identificationofrisk, the bankalsomakesan assessment of theuncertaintywhichrequiresadetailedapproachnot only philosophically but also operationally but also frombusiness environmentingeneral, depending on whereit operates. In addition, the determinationmust be madeclearto thestrategicand operationalobjectivesincludingthe mostcriticalfactorsforachieving theseobjectives.

Risk identification should be approached methodically where should ensure that all risks are found to arise from the bank activities.

Description of risk is part of the risk analysis and has as objective to describe the emergence of risks identified in a structured way.

Risk assessment is the final step of risk analysis which can be quantitative,

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quantitative or qualitative depending on the probability of occurrence, it can have consequences. After the completion of risk process is important to compare the estimated risks against risk criteria that the organization has created. At risk criteria are included costs associated benefits, legal, socio economic and environmental concerns of stakeholders. Risk assessment is used to make decisions about risks to the organization the importance of each risk in particular, which should be treated or admitted.

Information system within the bank should be well consolidated by creating the opportunity for access to different levels of management and operators. All participants in the risk management process should be informed by the circumstances of the risk management process, and the time and manner of decision making.

Risk treatment mainly involves risk control, mitigation, where its function extends further including risk avoidance, risk transfer, risk financing.

Risk reporting process should provide an efficient and effective functioning of the organization, internal controls in compliance with laws and regulations.

Finally, the monitoring process should ensure that controls on bank activities are appropriate and procedures are understood and followed.

Any monitoring and review process must also prove that the measures adopted, resulting in what was thought, were appropriate, for improvement and achievement of efficient decisions today that mistakes can be used to assess future risk management.

Methods of recognition of risks and their management techniques without risk model, such innovations would remain limited. Through these models is enabled the evaluation of the risk to have a balanced view of the risks and revenues.

### Kosovo's business environment and operations of commercial banks

Banking industry in the world is characterized by intense competition and considering the cost and offered banking products. Because of this competition banks are required to identify and adopt new ways and more efficient to win as many customers and gain their loyalty for a long time. On the other hand commercial banks also seek to reduce costs by providing the best possible conditions for existing borrowers. Trying to make it through differentiation and maximizing profits and minimizing losses from various risks (Levy-Yeyati, E. and A. MICCO, 2007).

Should be noted that in the past banks have been oriented more towards selling products, not concerned about the solvency of customers. In this way, they

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were interested to get the market shares to take advantage of the relative costs. But with the evolution and development of financial derivatives, expanding businesses, globalization and financial liberalization has made necessary the creation of an effective system of risk management by financial institutions.

The ability of a bank to identify, measure and monitor risks completely, is becoming a crucial parameter for its strategic positioning in the market. However there are some basic principles that apply to all financial institutions, regardless of size and complexity of the business, which are reflected as strongly risk management in banks.

The banking sector in Kosovo is well known that it is a new system and developing. Built after 1999, which has continued to grow, serving as the main actor of financial intermediation, while maintaining the stability of constituent components of liquidity, profitability and capital.

It should be emphasized that the banking sector in Kosovo is successfully developed by many international institutions and is regarded as a success story (IMF 2012). Since late 2000, when the first bank was established after the war, the total value of assets in the banking sector as shown in Table until 2011 has increased approximately 26 times.

Table 1: Bank Data in Billions in euros.

| Years | 2000 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|
| **Assets/Liabilities** | 0. 1 | 0. 98 | 1. 16 | 1. 43 | 1. 79 | 2. 07 | 2. 35 | 2. 66 |
| **Deposits** | 0. 1 | 0. 84 | 0. 92 | 1. 14 | 1. 42 | 1. 55 | 1. 71 | 2. 1 |
| **Credits** | 0. 02 | 0. 51 | 0. 64 | 0. 89 | 1. 19 | 1. 28 | 1. 42 | 1. 69 |

**Source: Year reports ofCBK 2001-2010 and monthly bulletins of CBK**

The banking sector in Kosovo is characterized by a large presence of foreign capital, where 89. 2% of all assets managed by foreign banks. With their presence these banks have contributed to the modernization of the financial system.

Here the banking sector remains highly concentrated. In late December 2013, the three largest banks together accounted for about 74% of banking sector assets, 74% of deposits and 71. 7% of loans. Level banking market concentrated is lower compared with 2008, when deposits and assets of three banks covered 90% of this market.

Despite the global financial crisis, the banking system continues to be well capitalized despite the decline in capital adequacy indicators (Capital Adequacy Ratio: CAR). With the aim of banking services to be closer to customers, commercial banks continued to expand their infrastructure, although in the last two years this rate has declined. This may have occurred because the banks have been operating in Kosovo market have managed to consolidate their presence well

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with opening bank branches throughout the territory of Kosovo, and thus slow down the pace of expansion may be due to measures taken by the banks to reduce expenditure in this regard.

## 4. 1 Performance and risks of the banking system in Kosovo

Although the global economy is in an unfavorable economic environment, where the banking sector continues to be positive. Although, the developments in the global economy contributed to the slowdown of economic growth in Kosovo, thus reflecting the decline in leading indicators of profitability and of easy increased risks banking sector for the period June 2011 - June 2013 (CBK 2013).

Due to the prudent leadership and adequate risk management that threatens the banking system, Kosovo continues to have a high durability where the level of liquidity continues to be quite satisfactory despite the slight downward trend of the main indicators of liquidity. Low exposure to liquidity risk of the banking sector is mainly attributed to the traditional banking model, where the structure of funding sources is dominated by deposits collected in the country which are characterized with lower cost and higher durability than other sources financing such as external financing and wholesale financing Rage ( wholesale funding ). Banking sector deposits constitute about 80 percent of the liabilities of the sector, and most of them (74 % in June 2013) are household deposits which are characterized by low degree of concentration. (CBK 2013).

Capitalizing of banking system in Kosovo is characterized by a high degree, which represents one of the most important indicators of the banking system, as a key pillar for potential losses in the event of a shock to the banking system.

Credit risk, despite the slight increase due to deteriorating loan portfolio quality continued to be well managed by banks, which continued to hold the value of provisions for loan losses at a higher level than the total value of non-performing loans. Also, the level of capitalization of the banking system Kosovo, which reflects the ability of the solvent system, continues to be quite satisfactory, significantly exceeding the minimum rate set by CBK and international regulations. In this way, the banking system remains characterized by low levels of liquidity risk, credit risk and solvency risk, which ranked it among the most stable banking systems in the region, taking into account also the continued growth of loans and deposits.

**Research Methodology**

In this paper are follow these steps (Malhorta and Birks, 2003).

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- Problem definition
- Research objectives
- Hypothesis
- Characteristics of respondents and research results
- Analysis of the correlation

**Problem Definition**

Commercial banks in Kosovo are ready to upgrade their skills in order to successfully cope with banking risks through various techniques, and therefore are trying to identify the most effective method.

It is important to note the commercial banks in Kosovo are well developed, but is nevertheless Kosovo commercial banks are reluctant to pursue risks and knowledge of successful techniques.

Should be noted that commercial banks in Kosovo have created a risk management specialist units with specialized staff of IT (systems) and systematic procedures. But the most important reason is that the banks should be able to gather lots of information about the management of risk and thereby identify their assets and to meet the needs of the organization.

**Research objectives**

The purpose of this research is to be a quantitative research. Specific research is about risk management and its effects on commercial banks in Kosovo. In addition, the study deals with the identification of normal interactions between two variables. So quantitative research is a statistical analysis and experimental basis which may prove a concept or idea (McCullough, 2004). For the collection of primary data and for a specific study is the questionnaire (Pallant, 2001) which enables researchers to study relationships between variables. In addition to this, primary research data has to do with the secondary data records that have already been collected for other purposes (Malhotra and Birks 2003, p85).

In this research, questionnaire consists of 25 questions and is divided into three parts:

- The first part of the questionnaire contains questions regarding the structure and operation of the bank.
- The second part contains questions regarding the use of methods, policies and risk management techniques.
- The third part contains questions regarding the risks and processes relating to the operation of risk management and their impact on company revenues.

The questionnaire includes closed and open questions in the form of a

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Likert scale in order to examine how participants agree or disagree, in order to avoid their total deviations which can send to misunderstandings. This form of the questionnaire can easily transferred in digital design which is suitable for statistical analysis

### Hypotheses: Declarations

The company if it has identified the problem and research objectives it can continue with the statement of hypothesis which accordingtoGhauri et al (1995) is a formulation of a statement in a particular phenomenon. In a statement to the hypothesis, there are two hypotheses: (H0) which means that there is no relationship between two variables and the alternative hypothesis (H 1), which states that there is a relationship between two variables (Sekaran, 2003).

This paper explains and analyzes the banking risks, and how they are treated by means of risk management. Below are presented these assumptions:

a. H 01: Risk management methods used by commercial banks in Kosovo are not related with elimination ofthe risks associated with the bank.
b. H 1: Risk management methods used by commercial banks in Kosovo are related to the elimination of banking risks;
c. H 02: Risk management as a process of commercial banks in Kosovo is not associated with the company's revenues, and
d. H 2: Risk management as a process of commercial banks in Kosovo is associated with the company's revenues.

In the first hypothesis as the independent variable methods of risk management deals where commercial banks are not associated with risk management. While the dependent variable is taken as risk management methods used by commercial banks is associated with the elimination of banking risks

In the second hypothesis of independent variables Risk Management is taken as the process by commercial banks not associated with the company's revenues.

While as the dependent variable is taken Risk Management as the process by commercial banks associated with the company's revenues.

The dependent and independent variable mainly used for experimental research where some variables are manipulative (are independent) from the initial reaction of the subject, while some variables are dependent on the manipulation

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and experimental conditions.

### Characteristics of the Respondents and Survey Results

The research are included seven commercial banks which constitute 100% of commercial banks, where the response rate has reached 100%. Questionnaire responses were codified and are imported into social science research methods (SPSS).

### Section I

1: Mode of banks operations

According to questionnaire, we have reached the conclusion that: 28% of banks have started their work over 11 years, while 57% of banks function as four or seven years.

All banks have stated that there are 2 or more risk management departments. Capital structure of most of the commercial banks operating in Kosovo is comprised possessing foreign owners about 71. 4%.

There are 57% of employees that work throughout risks departments have work experience of over 8 year and in departments have 4 to 6 employees. Also, 57. 1% of managers have declared that the scale of assessment of their work is related to the risk management, 85. 7% of banks have declared that trainings are organized once a year and are effective.

### Section II

### 2: Changing policies of risk management

By analysing the responses associated with changing policies and raising the voice we bring these results where 57. 1% of banks or in average 3: 43 of banks take opinion of the risk managers associated with regulating and establishing sound policies dealing with risk management. Also based on the results, all banks inform risk managers on time in case there is any change in policy.

### 2. 1: Methods used for risk analysis

All banks invest heavily in research and development methods in order to find more effective ways to cope with banking risks. Greater use of the methods is the analysis of the market and statistical inference with 85. 7% SWOT analysis and business continuity planning with 71. 4%, and the stress test and the decision taken under conditions of risk and uncertainty modeling and real option with 57. 1%.

### 2. 2: **The use of techniques to identify risks**

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Commercial Banks in Kosovo use many techniques to identify risks. Techniques preferred by banks are those audit and inspection as well as business studies looking internal processes and external factors that might impact the risk with 85. 7%, followed closely by those Brainstorm, Incident Investigation and interviews with 71. 4 % and less preferred banks Benchmarking with industry is 57. 1%.

**Section III**

### 3. 1. The importance of risk in commercial banks in Kosovo

All banks surveyed consider that the credit risk and the liquidity risk with the average risk of 100% is more important that they should be focused, then with 71. 4% operational risk is considered, currency risk and interest rate risk with 42. 9%

### 3. 1. Benefits that can be obtained from the liquidity risk management

Benefits that can be obtained from management of liquidity risk is that 85. 7% of respondents are under the direction of central bank demand, 51. 7% may have the ability to contract new loans and other investments to increase profitability and can meet its obligations in the event of crisis, 42. 9% of respondents stated that they can lend to low interest rate during the time when banks remain liquid well.

### 3. 2 Benefits which are taken from operational risk management

Benefits which are taken from operational risk management by the respondents have taken these results; 57. 1% can put limitations fraud against consumers and staff, there is proper operation of IT systems, also 57. 1% think reduction of internal errors that affect net income and compliance tasks, 42. 9% of respondents stated that there is no information about the secret.

### 3. 3 Benefits that can be obtained from the management of market risk.

Benefits which can be achieved by managing market risk have stated 57. 1% of respondents that restrictions may be risks from risks (such as interest rates, foreign currency exchange, and liquidity risk). , While 42. 9 said that this create immunity against adverse economic forces, 85. 7 also stated that this risk provides protection from the cost of borrowing financial products.

### 4. Elimination of banking risks

More specifically, the question 18, 19, 20, 21, are related to the elimination

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of bank risks which relate to the first hypothesis. As seen in the table that the average of these variables is 4606. For this reason, the majority of respondents agree or strongly agree with the risk management processes to eliminate banking risks.

## 5. Bank earnings

While question 23, 24 refers to the second hypothesis, which tells us that revenues are affected by the risk management process used by commercial banks. The average of these two questions is 4: 57, which means that most banks have raised income due to the use of risk management processes.

### Analysis of correlation

Correlation is a measure of interconnectedness between the two variables (Armitage and Colton, 1999). It has a wide application in economics, business and social sciences in general. The correlation coefficient gives us a mathematical value to measure the liaison strength of the linear relationship between two variables.

The first hypothesis is formed by the survey which seeks to test whether the risk management methods of the commercial banks in Kosovo (without dependent variable) is related to the field of banking risks (dependent variable). To prove this hypothesis we used the correlation coefficient software by SPSS.

Table 5 shows the correlation results. The value of the correlation coefficient is $r_s = 0.8331$ and p-value is $0.020 < 0: 05$ which show that they have a strong positive relationship. Ho hypothesis is accepted but not accept the alternative hypothesis H01 that shows that the risk management methods used by commercial banks in Kosovo are associated with eliminating the banking risks.

Table 2. Coefficient of correlation risk management methods to eliminate the risks associated with banking.

**Correlations**

|  |  | Methods | Processes |
|---|---|---|---|
| RMM | Pearson Correlation | 1 | -. 833[*] |
|  | Sig. (2-tailed) |  | . 020 |
|  | N | 7 | 7 |
| EBR | Pearson Correlation | -. 833[*] | 1 |

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| | | | |
|---|---|---|---|
| | Sig. (2-tailed) | . 020 | |
| | N | 7 | 7 |

*. Correlation is significant at the 0. 05 level (2-tailed).
RMM= Risk management methods
EBR=Elimination of Banking Risks

The hypothesis of risk management as a process (independent variable) from commercial banks in Kosovo is linked to company earnings (dependent variable) have been tested by the correlation test. According to the table 5. 1 we have gained these results: the value rs = 0. 925 and p value = 0. 003, indicating that there is a strong correlation (p-value <0: 05), So hypothesis H02 is not accepted but the alternative hypothesis H02 is accepted. So it should be noted that risk management as a process used by commercial banks in Kosovo affects the improvement of the company (raising revenue).

Table 3: Coefficient correlation as process management in raising revenue

**Correlations**

| | | Processes | Earnings |
|---|---|---|---|
| RMP | Pearson Correlation | 1 | . 925** |
| | Sig. (2-tailed) | | . 003 |
| | N | 7 | 7 |
| CR | Pearson Correlation | . 925** | 1 |
| | Sig. (2-tailed) | . 003 | |
| | N | 7 | 7 |

**. Correlation is significant at the 0. 01 level (2-tailed).
MRP= Risk management as a process
CR= ompany's revenue

## Conclusion

Banks cannot operate without risk on one hand and on the other hand no bank can be immune to risk. Risk management involves the maintenance of losses and value of bank within acceptable margins. Types of risks that include banks in general are: credit risk, liquidity, operational, market and legal risk. Regarding risk management, commercial banks in Kosovo reflect stability through policies and procedures set by the CBK. Each bank prepares and submits reports to the CBK regarding large exposures, administration and operations, liquidity, solvency and profitability.

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The main risks confronting banks is credit risk, which is defined as: "Potential" that a debtor will fail to meet its obligations (principal, interest, commissions), in time or under the full terms of contracted credit''. Banks are required by law to maintain the account of loan loss reserves to cover these loans.

Operational risk management by commercial banks in Kosovo is made under constant control by senior management and proper functioning of the IT systems. Worldwide experience has shown that a small mistake on the part of employees associated with poor practices of risk management continues to be a dominant factor in the failure of banks and banking crises.

Banking risk management is increasingly changing the process of being influenced by general factors such as the institution's objectives, financial trends, government regulation, capital structure, and the structure of liabilities and assets.

Each bank during its business is not avoidable in terms of facing different types of risks that could have a potentially negative effect on their businesses, but with better management of risks, losses can turn into opportunity.

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