

Risk Management Strategies in Financial Institutions

Strategi Manajemen Risiko di Lembaga Keuangan

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ABSTRACT

This research aims to explore the factors that influence the effectiveness of risk management strategies in financial institutions. Through analysis of variables such as the level of risk awareness across the organization, the level of success in identifying and mitigating the impact of risks, and employee participation in the risk management process, our findings show that these factors have a significant influence on the effectiveness of risk management strategies. Financial institutions that have a strong risk culture, supported by a high level of risk awareness and open communication about risk across the organizational hierarchy, tend to be more successful in managing risk and achieving their goals. The practical implication of this research is the importance of strengthening risk culture, increasing risk awareness throughout the organization, and encouraging active employee participation in the risk management process to increase the effectiveness of risk management strategies in financial institutions.

Keywords: Financial Institutions, Risk Management Implementation, Strategic

ABSTRAK

Penelitian ini bertujuan untuk mengeksplorasi faktor-faktor yang mempengaruhi efektivitas strategi manajemen risiko di institusi keuangan. Melalui analisis variabel seperti tingkat kesadaran risiko di seluruh organisasi, tingkat keberhasilan dalam mengidentifikasi dan mengurangi dampak risiko, serta partisipasi karyawan dalam proses manajemen risiko, temuan kami menunjukkan bahwa faktor-faktor ini memiliki pengaruh yang signifikan terhadap efektivitas strategi manajemen risiko. Institusi keuangan yang memiliki budaya risiko yang kuat, didukung oleh tingkat kesadaran risiko yang tinggi dan komunikasi terbuka tentang risiko di seluruh hierarki organisasi, cenderung lebih berhasil dalam mengelola risiko dan mencapai tujuan mereka. Implikasi praktis dari penelitian ini adalah pentingnya memperkuat budaya risiko, meningkatkan kesadaran risiko di seluruh organisasi, dan mendorong partisipasi aktif karyawan dalam proses manajemen risiko untuk meningkatkan efektivitas strategi manajemen risiko di institusi keuangan.

Kata Kunci: Institusi Keuangan, Implementasi Manajemen Risiko, Strategis

Introduction

Risk management is an important strategy for financial institutions, especially commercial banks, to ensure stable and successful business operations. Weak capitalization, poor management, weak internal controls, poor corporate governance, and poor risk management practices are some of the major causes of bank distress. However, there are challenges in implementing risk management strategies, such as inadequate resources, lack of expertise, and regulatory constraints. It is important for financial institutions to develop comprehensive risk management strategies tailored to their specific needs and increase their awareness of potential risks they face (Kibe, 2014). A robust risk culture within financial institutions is also important, which involves promoting a risk-aware mindset among employees and encouraging a culture of open communication and transparency. Risk management is of vital importance for any financial institution to keep its information systems

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secure at an acceptable level. The main tasks for the implementation of such requirements involve the determination of the causes of risks, the estimation of risk occurrence probability, and the evaluation of risk consequence severity, which are all included in the risk analysis (Kiss,2016).

Common risks faced by financial institutions include weak capitalization, poor management, weak internal controls, poor corporate governance, and poor risk management practices (Wadhwa,2018). Additionally, challenges in implementing risk management strategies can arise from inadequate resources, lack of expertise, and regulatory constraints (Adegboye ,2019). Non-banking financial institutions (NBFIs) also face risks related to diversification, hedging, and insurance, along with challenges such as inadequate resources and lack of expertise in implementing risk management strategies (Elamer,2018). The 2008 financial crisis led to significant changes in risk management strategies for financial institutions in Hungary, with a focus on adjusting policies to regulatory frameworks and managing various risks (Curti,2023). Financial institutions prioritize risk management for their information systems, involving tasks such as determining the causes of risks, estimating risk occurrence probability, and evaluating risk consequence severity (Mishchenko,2021).

Financial institutions can increase their awareness of potential risks by developing comprehensive risk management strategies tailored to their specific needs. This involves using various risk management strategies such as diversification, hedging, and insurance to manage risks. Additionally, it is important to promote a robust risk culture within financial institutions, which involves fostering a risk-aware mindset among employees and encouraging a culture of open communication and transparency (Bugalla,2021). Furthermore, the establishment of a separate board-level risk committee has been recommended to manage various risks and prevent excessive risk-taking (Aloqab,2018). In the context of emerging risks such as cyber risk, financial institutions need to develop a preliminary cyber risk definition and classification for risk management purposes to ensure consistent measurement and management of this evolving threat (Dugguh,2019).

Financial institutions or banks are institutions or entities that provide various financial services to the public or customers, including raising funds, providing loans, investments, and various other services related to financial activities. The main objective of financial institutions is to allocate financial resources from those who have funds to those who need funds, thereby supporting economic growth and facilitating various economic activities. Financial institutions can operate in various forms, including banks, credit institutions, insurance companies, securities companies, pension funds, and other financial institutions. The following are some examples of common financial institutions (Pakhchanyan, 2019) (Parvin, 2020): (1) Bank: A bank is a financial institution that provides various banking services, including accepting deposits, providing loans, financing, payments, and other services to its customers . (2) Credit Institutions: Credit institutions such as credit cooperatives or financing institutions provide loans to individuals or businesses for various purposes, ranging from consumer needs to financing business projects. (3) Insurance Companies: Insurance companies provide various types of insurance products, including life insurance, health insurance, vehicle insurance, and property insurance, to protect their customers from possible financial risks. (4) Securities Companies: Securities companies provide services such as securities trading, investment advisory, portfolio management, and brokerage services for financial transactions such as stock and bond offerings. (5) Pension Funds: Pension funds or pension fund depository institutions manage the pension fund investments of participants with the aim of providing future retirement income. Financial institutions play an important role in the economy by allocating financial resources efficiently, facilitating economic growth, and providing the financial services required by society and businesses. The existence of financial institutions also helps reduce financial risks by providing products and services that enable risk diversification and financial protection.

Risk management strategy is a series of steps or actions taken by organizations or individuals to identify, evaluate, reduce or transfer risks that may occur in their operations or activities. It includes a comprehensive process for managing potential risks with the aim of protecting value, achieving goals and maintaining business continuity. There are various strategies that can be used in risk management, depending on the type of risk faced and the risk tolerance of the organization or individual. Some general strategies in risk management include (Rampini, 2020) (Khatib, 2020): (1) Risk Prevention: Involves identification and action to prevent risks from occurring wherever possible. This may include limiting certain activities, improving processes or infrastructure, or training to reduce the likelihood of risks occurring. (2) Risk Transfer: This strategy involves transferring risk to another party, such as insurance or derivative contracts. In this way, organizations or individuals can reduce the impact of possible risks, although often at the cost of premiums or other payments. (3) Risk Mitigation: This involves reducing the impact of possible risks by taking appropriate steps. Examples could be diversification of investment portfolios, use of hedging, or implementation of strong internal controls. (4) Risk Monitoring and Control: This strategy focuses on continuous risk monitoring and control to identify changes in the risk environment and take necessary actions to manage them. This includes regular monitoring, performance evaluation, and adjusting risk management strategies as needed. (5) Risk Absorption: This strategy involves accepting risks as they occur without taking specific actions to avoid them. This may be necessary when the risk cannot be avoided or transferred at a reasonable cost, and the organization or individual must be prepared to bear the impact of the risk. Implementing appropriate and effective risk management strategies can help organizations or individuals to manage risks better, improve performance and better achieve their goals. Apart from that, these strategies can also help in avoiding unwanted losses and ensuring long-term business sustainability.

Financial institutions need a risk management strategy because they operate in an environment full of uncertainty and risk. Following are some of the reasons why risk management strategies are important for financial institutions (Vitolla, 2020) (Karsh, 2021): (1) Protection Against Losses: Financial institutions are involved in various activities such as lending, investing, and asset management. Risks of loss such as creditor default, investment losses, or decline in asset value can threaten the financial stability and operational sustainability of financial institutions. Risk management strategies help financial institutions to identify, evaluate and manage these risks in an appropriate manner. (2) Compliance with Regulatory Requirements: Financial institutions are subject to various regulations and standards set by financial regulators. One of the main requirements needed is the implementation of an effective risk management strategy. By having a good risk management system, financial institutions can ensure that they comply with applicable regulations and avoid sanctions or fines that may be imposed by regulators. (3) Systemic Risk Management: Systemic risk is a risk that can spread throughout the financial system and have a significant impact on market stability. Financial institutions are often an integral part of the financial system, and a crisis or failure in a financial institution can have a far-reaching domino effect. Risk management strategies help financial institutions to identify and manage these systemic risks by minimizing their potential impact. (4) Maintain Customer Trust: Customer trust is a valuable asset for financial institutions. By having a strong risk management strategy, financial institutions can demonstrate their commitment to maintaining the security and financial stability of their customers. This helps maintain customer trust and strengthens long-term relationships with them. (5) Optimization of Financial Performance: Effective risk management strategies can help financial institutions to optimize their financial performance. By minimizing unwanted or unexpected risks, financial institutions can improve operational efficiency, reduce losses, and achieve better results in terms of investment portfolio management and product development. Thus, risk management strategies are not only important for the operational

continuity of financial institutions, but are also a prerequisite for ensuring market stability, consumer protection and sustainable economic growth.

Risk management is a crucial aspect in the operations of financial institutions. In this scope, risk management strategies become an important focus for decision makers in financial institutions. This research aims to explore and analyze various risk management strategies that have been developed and implemented in financial institutions (Orichom, 2021). The research method used is a systematic review of the literature. The importance of this research lies in the vital role of financial institutions in the economy. As institutions that manage public funds, financial institutions have a big responsibility in mitigating risks that may occur (Siampondo, 2023).

Financial institutions face various types of risks, including: (1) Credit Risk: The risk of loss from a borrower or counterparty failing to fulfill their obligations. (2) Market Risk: The risk of losses in on and off-balance-sheet positions arising from adverse movements in market prices. (3) Operational Risk: The risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events. (4) Liquidity Risk: The risk of not being able to meet short-term obligations without incurring unacceptable losses. (5) Interest Rate Risk: The risk of economic losses due to changes in interest rates. (6) Regulatory and Compliance Risk: The risk of legal or regulatory sanctions, material financial loss, or loss to reputation a financial institution may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organization standards, and codes of conduct applicable to its activities. (7) Reputational Risk: The risk of loss arising from damage to a financial institution's reputation. (8) Strategic Risk: The risk of loss from a poor business decision or the improper implementation of a decision. These risks require comprehensive risk management strategies tailored to the specific needs of financial institutions, along with measures to increase awareness and mitigate potential risks (Curti,2023) (Siampondo,2023).

The main phenomenon underlying this research is the increasing complexity of risks faced by financial institutions, such as credit risk, market risk, liquidity risk and operational risk. In dealing with this phenomenon, financial institutions need effective and up-to-date risk management strategies. The emerging research gap is a lack of in-depth understanding of the various risk management strategies available to financial institutions, as well as a lack of thorough analysis of the effectiveness and suitability of these strategies in dealing with specific risks. Therefore, this research will make an important contribution to filling this knowledge gap.

Research Methods

This research uses a systematic literature review method. The first stage in this process is collecting related articles through searches using certain keywords in academic databases such as Web of Science, ScienceDirect, Google Scholar, Scopus, IEEE Xplore. Keywords used include "risk management strategies", "financial institutions". After conducting a search, we obtained a number of articles relevant to this research topic.

Next, we applied inclusion and exclusion criteria to filter the articles. Articles included must be related to risk management strategies in the context of financial institutions. We also pay attention to the accuracy and reliability of the information source and the year the article was published to ensure the information obtained is current and relevant. After the filtering process, we obtained the number of articles that met the research criteria.

The number of articles we filtered was 40 articles published within the last five years. These articles were then thoroughly analyzed to identify various risk management strategies that have been proposed and implemented in financial institutions. This analysis was carried out by considering the effectiveness and suitability of these strategies in overcoming the risks faced by financial institutions.

With this systematic review method of the literature, we hope to provide an in-depth understanding of the various risk management strategies available to financial institutions, as

well as provide valuable insight into the effectiveness and suitability of these strategies in dealing with the specific risks faced by financial institutions at the moment.

Results and Discussion

Effectiveness of Risk Management Strategy

1. The level of success in identifying the risks faced

This hypothesis confirms that the better a financial institution is at recognizing possible risks, the greater the likelihood of success in implementing risk management strategies. Accurate and comprehensive risk identification is an important foundation for the development of appropriate and effective risk management strategies. By clearly knowing the risks they face, financial institutions can take appropriate steps to manage these risks, thereby increasing the chances of success in achieving their goals and minimizing potential negative impacts that may arise. Therefore, the level of success in identifying the risks faced is an important indicator in assessing the overall effectiveness of the risk management strategy implemented by a financial institution (Park, 2020).

Hypothesis: The higher the level of success in identifying the risks faced, the more effective the risk management strategy in financial institutions will be.

2. The level of success in implementing risk management strategies that are appropriate to the identified risks

This hypothesis states that if financial institutions succeed in implementing risk management strategies that match the risks that have been identified, then they will be more successful in managing risk overall. Strategies tailored to the specific risks faced enable financial institutions to respond to challenges more effectively and efficiently. By using appropriate and relevant strategies, financial institutions can reduce the potential negative impacts that may arise from these risks. This allows financial institutions to maintain operational stability, protect asset values, and minimize financial losses. Therefore, the level of success in implementing risk management strategies that are appropriate to the identified risks is key in achieving overall effectiveness of risk management in a financial institution (Liu, 2023).

Hypothesis: If the level of success in implementing risk management strategies corresponds to the identified high risks, then the effectiveness of risk management strategies in financial institutions will increase.

3. The level of success in reducing the impact of the risks that occur

This hypothesis indicates that the success of a risk management strategy can be measured by the ability of financial institutions to reduce the negative impact of the risks that occur. When financial institutions succeed in managing risks effectively, they are able to reduce financial losses or other negative impacts that may arise as a result of these risks. By using appropriate and targeted strategies, financial institutions can identify, evaluate and address risks in a way that minimizes potential losses. This allows financial institutions to maintain financial stability, protect asset values, and maintain their operational performance. Therefore, the ability of financial institutions to reduce the impact of risks that occur is an important indicator in assessing the overall effectiveness of the risk management strategies implemented (Kedarya, 2023).

Hypothesis: The higher the level of success in reducing the impact of risks that occur, the higher the effectiveness of risk management strategies in financial institutions.

4. The level of success in minimizing financial losses due to these risks

This hypothesis illustrates that financial institutions that are successful in implementing risk management strategies will have the ability to minimize financial losses that arise as a result of the risks they face. By using appropriate and effective strategies, financial institutions

can identify, evaluate and manage risks in a way that reduces the possible financial impact. This allows financial institutions to maintain their financial stability, protect asset values, and maintain operational performance in situations that may be full of uncertainty and risk. Therefore, the ability of financial institutions to minimize financial losses due to these risks is an important indicator in assessing the success and effectiveness of the risk management strategies implemented (Saeidi, 2021).

Hypothesis: If the level of success in minimizing financial losses due to these risks is high, then the effectiveness of risk management strategies in financial institutions will increase.

5. Level of risk awareness across the organization

This hypothesis indicates that the higher the level of risk awareness throughout a financial institution's organization, the stronger the risk culture will be formed within it. High risk awareness reflects employees' better understanding of the risks that may occur in their work environment. When risk awareness is widespread throughout the organization, employees are more likely to be proactive in identifying potential risks and contributing to managing those risks. This helps create a risk-responsive work environment, where each individual has a responsibility to ensure that risks are identified and addressed appropriately. Thus, the level of risk awareness throughout the organization is an important indicator in assessing the strength of the risk culture in a financial institution, which in turn will influence the effectiveness of the risk management strategy implemented (Alabdullah, 2022).

Hypothesis: The higher the level of risk awareness throughout the organization, the higher the effectiveness of risk management strategies in financial institutions.

6. The level of employee participation in the risk management process

This hypothesis illustrates that in financial institutions that have a strong risk culture, there is a high level of employee participation in the risk management process. A high level of participation indicates that employees feel involved and encouraged to contribute to identifying, evaluating and managing the risks faced by their organization. When employees feel that their opinions and contributions are valued in the risk management process, they tend to be more active and proactive in participating to ensure that these risks can be addressed appropriately. This not only helps increase the effectiveness of the risk management strategy implemented, but also strengthens the existing risk culture within the organization. Thus, the level of employee participation in the risk management process is an important indicator in assessing how strong the risk culture is in a financial institution, which will ultimately influence the success of the risk management strategy implemented (Adelusi, 2022).

Hypothesis: If the level of employee participation in the risk management process is high, then the effectiveness of risk management strategies in financial institutions will increase.

7. The level of open communication about risks across the organizational hierarchy

This hypothesis illustrates that in a financial institution that has a strong risk culture, there is a high level of open communication about risk throughout the organizational hierarchy. Open and transparent communication about risks plays a key role in strengthening shared awareness and understanding of the risks faced by the organization. When information about risk can be effectively shared across all levels of the organizational hierarchy, it allows each member of the organization to have a better understanding of risk and its impact on overall organizational goals. Apart from that, open communication also supports a better decision-making process, because it allows stakeholders to collaborate in evaluating the risks faced and determining appropriate strategies to manage them. Thus, the level of open communication about risk throughout the organizational hierarchy is an important indicator in assessing the strength of risk culture in a financial institution, as well as in determining the effectiveness of the risk management strategies implemented (Mallekoote, 2022).

Hypothesis: If the level of open communication about risk throughout the organizational hierarchy is high, then the effectiveness of risk management strategies in financial institutions will increase.

8. Level of trust and transparency in risk-related decision making

This hypothesis illustrates that in a financial institution that has a strong risk culture, there is a high level of trust and transparency in risk-related decision making. Trust between organizational members and transparency in the decision-making process creates an environment in which risks can be identified, evaluated and managed more effectively. When stakeholders have trust in each other and feel that the risk-related decision-making process is transparent, they are more likely to share information, collaborate, and participate in risk management efforts. This not only helps reduce the likelihood of errors or inappropriate decisions, but also strengthens a shared understanding of risk and its impact on organizational goals. Thus, the level of trust and transparency in risk-related decision making is an important indicator in assessing the strength of risk culture in a financial institution, as well as in determining the effectiveness of the risk management strategies implemented (Li, 2020).

Hypothesis: The higher the level of trust and transparency in risk-related decision making, the higher the effectiveness of risk management strategies in financial institutions.

Research Framework

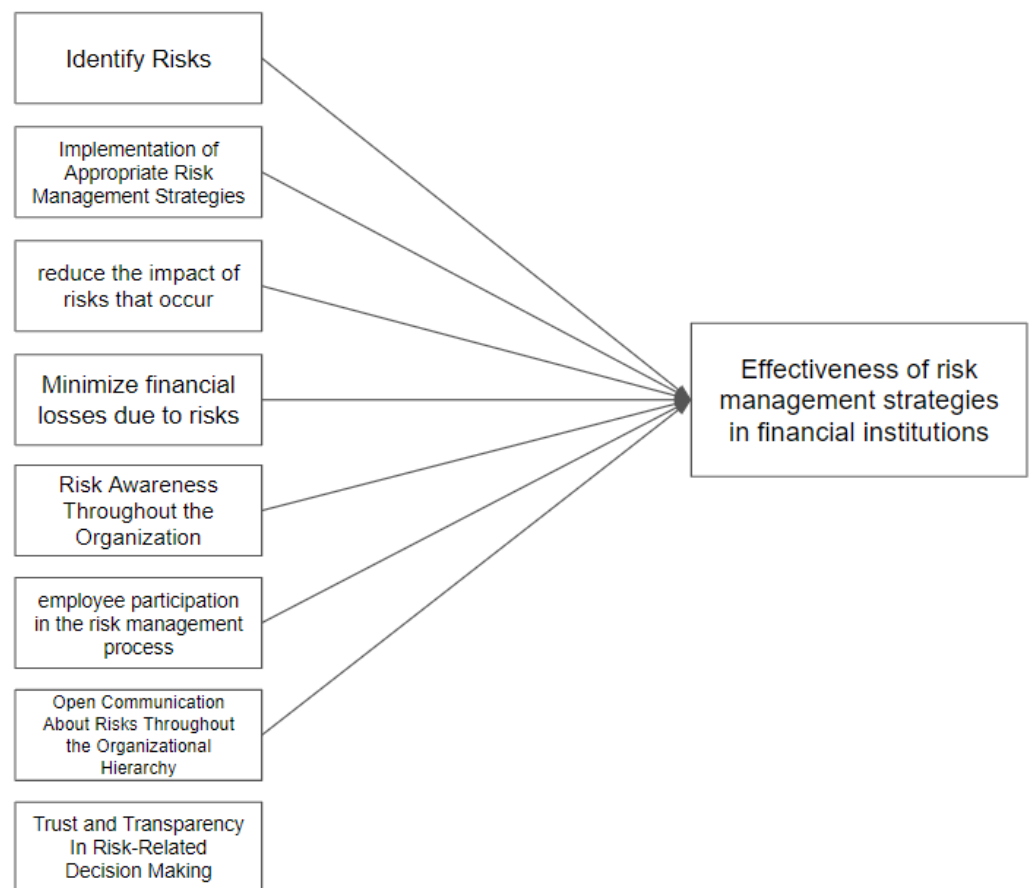


Figure 1. Research Framework

Hypothesis:

1. The higher the level of success in identifying the risks faced, the more effective the risk management strategy in financial institutions will be.

2. The higher the level of success in implementing risk management strategies in accordance with identified high risks, the effectiveness of risk management strategies in financial institutions will increase.
3. The higher the level of success in reducing the impact of risks that occur, the higher the effectiveness of risk management strategies in financial institutions.
4. The higher the level of success in minimizing financial losses due to these high risks, the effectiveness of risk management strategies in financial institutions will increase.
5. The higher the level of risk awareness throughout the organization, the higher the effectiveness of risk management strategies in financial institutions.
6. The higher the level of employee participation in the high risk management process, the effectiveness of risk management strategies in financial institutions will increase.
7. The higher the level of open communication about risk throughout the high organizational hierarchy, the greater the effectiveness of risk management strategies in financial institutions.
8. The higher the level of trust and transparency in risk-related decision making, the higher the effectiveness of risk management strategies in financial institutions.

Conclusion

In this research, we identify key factors that influence the effectiveness of risk management strategies in financial institutions. Through analysis of variables such as the level of risk awareness across the organization, the level of success in identifying and mitigating the impact of risks, and employee participation in the risk management process, we found that these factors have a significant influence on the effectiveness of risk management strategies. Our findings show that financial institutions that have a strong risk culture, supported by high levels of risk awareness and open communication about risk across the organizational hierarchy, tend to be more successful in managing risk and achieving their goals. The practical implication of this research is the importance of strengthening risk culture, increasing risk awareness throughout the organization, and encouraging active employee participation in the risk management process to increase the effectiveness of risk management strategies in financial institutions.

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