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## **CONCEPT AND CLASSIFICATION OF BANKING RISKS**

### **Abstract**

*The banking sector plays a crucial role in maintaining economic stability, allocating capital, and ensuring the efficiency of financial intermediation. However, because banks operate under conditions of uncertainty and exposure to diverse external and internal pressures, they face a wide spectrum of risks. These risks, when not effectively identified and managed, can lead to severe financial distress, institutional failures, or even systemic crises, as illustrated by the global financial crisis of 2008 (Acharya & Richardson, 2009). The concept of banking risk therefore encompasses not only the probability of financial loss but also the broader vulnerability of banking institutions to market contingencies, operational failures, and macroeconomic volatility.*

*In contemporary financial systems, regulatory bodies emphasize the need for robust risk management practices, requiring banks to adopt international frameworks such as the Basel Accords, which classify risks into measurable components and prescribe capital adequacy requirements (Basel Committee on Banking Supervision, 2017). Understanding the classification of banking risks is thus essential not only for regulatory compliance but also for the strategic decision-making processes within financial institutions. This paper provides a comprehensive overview of the nature of banking risks and presents a systematic classification based on academic literature and international standards.*

**Keywords:** *risk, financial banking, efficiency, financial crisis, strategic decision, management.*

### **The Concept of Banking Risk**

Banking risk is generally understood as the probability that an event or action will adversely affect a bank's ability to achieve its financial objectives. Traditional financial theory distinguishes between measurable risks and unmeasurable uncertainty, following Knight's (1921) foundational distinction. In banking, risk arises from exposure to borrowers, market fluctuations, operational disruptions, technological vulnerabilities, and legal or reputational challenges. Unlike other enterprises, banks operate with high leverage and maturity mismatches, making them more sensitive to shocks.

From an economic perspective, banking risk reflects the inherent tension between profitability and safety. Banks must take risks to generate returns but must also remain prudent to maintain solvency. Modern risk theory emphasizes this balance through the concepts of risk appetite, risk tolerance, and risk governance frameworks (Hull, 2018). As financial markets globalize, interconnectedness amplifies the transmission of risks across institutions, which widens the need for accurate classification and monitoring.

## **Classification of Banking Risks**

The classification of banking risks is a fundamental step in risk management because it enables institutions to structure their internal processes, allocate capital, and apply targeted mitigation strategies. The Basel regulatory framework provides the foundational taxonomy for modern banking risk classification, which consists of three major categories: **credit risk**, **market risk**, and **operational risk** (BCBS, 2011). However, academic literature expands these groups to include liquidity, legal, reputational, strategic, and systemic risks.

Below is a structured discussion of the essential risk categories.

### **Credit Risk**

Credit risk refers to the possibility that a borrower will fail to meet contractual obligations, causing financial loss to the bank. It is the most significant risk for commercial banks, often constituting more than 50% of total risk exposure (Saunders & Allen, 2020). Credit risk is influenced by borrower characteristics, macroeconomic stability, sectoral vulnerabilities, and information asymmetry. The increasing use of credit scoring models, expected credit loss (ECL) frameworks, collateralization, and portfolio diversification demonstrates the theoretical and practical complexity of this risk type.

### **Market Risk**

Market risk arises from fluctuations in interest rates, exchange rates, equity prices, and commodity prices. Banks engaged in trading activities or holding market-sensitive assets are particularly exposed. Interest rate risk, a key sub-category, affects the economic value of a bank's capital and future earnings due to rate volatility. Exchange rate risk affects foreign currency-denominated assets and liabilities. Market risk management relies heavily on quantitative methods such as Value-at-Risk (VaR), stress testing, and scenario analysis (Jorion, 2007).

### **Liquidity Risk**

Liquidity risk emerges when a bank is unable to meet short-term obligations due to insufficient liquid assets. This risk is closely linked to depositor behavior, market disruptions, and confidence shocks. The 2008 crisis demonstrated how quickly liquidity shortages can escalate into full-scale solvency crises. Basel III introduced the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) to strengthen liquidity buffers globally (BCBS, 2013).

### **Operational Risk and Its Sub-categories**

Operational risk refers to the possibility of loss resulting from inadequate or failed internal processes, human factors, technological failures, or external events. Unlike credit and market risks, operational risk is not directly tied to market performance but rather to the internal functioning of the bank. The Basel II framework formally recognized operational risk as a major risk category and required banks to hold capital against its potential losses (BCBS, 2006). This inclusion reflects the increasing frequency of cyber-attacks, fraud incidents, and system failures in modern financial institutions.

The scope of operational risk covers a wide range of subcategories, including information system disruptions, cybersecurity threats, internal misconduct, human error, natural disasters, and third-party failures. Human-related factors such as inadequate training, non-compliance with internal procedures, or intentional fraudulent behavior often account for a substantial proportion of operational losses. Technological risks have grown significantly due to digital transformation in banking, with cyber-attacks becoming one of the most critical challenges (Chernobai et al., 2019). Consequently, banks rely on key risk indicators (KRIs), internal loss databases, and advanced measurement approaches (AMA) to quantify operational risk exposure.

### **Legal and Compliance Risk**

Legal risk arises when a bank faces financial losses due to violations of laws or regulations, contractual disputes, or inadequate legal documentation. Compliance risk, often grouped with legal risk, involves failure to adhere to regulatory requirements, internal policies, or ethical standards. Modern banking is highly regulated, and legal frameworks encompass anti-money laundering (AML), counter-

terrorism financing (CTF), consumer protection, credit reporting standards, and data security requirements.

Failure to meet compliance standards may result not only in fines and penalties but also in severe reputational consequences. International institutions such as the Financial Action Task Force (FATF) provide global guidelines, while national regulators impose compliance reporting obligations. Legal risk management includes contract standardization, regulatory audits, legal reviews, and monitoring of changing legislation. As cross-border financial transactions increase, banks must frequently adapt to multiple legal systems, which further complicates compliance structures.

### **Reputational Risk**

Reputational risk refers to the potential loss resulting from negative public perception, media coverage, or stakeholder distrust. Although difficult to quantify, reputational damage can lead to loss of customers, decreased deposits, increased funding costs, and long-term strategic decline. This risk is often a consequence of other risks, such as compliance failures, fraud incidents, cyber breaches, or unethical behavior.

In the digital era, information spreads rapidly through social media and online platforms, making banks more vulnerable to sudden reputational shocks. Effective reputational risk management requires transparent communication, ethical governance, strong customer protection mechanisms, and crisis-response planning (Schwaiger, 2004). Banks increasingly adopt environmental, social, and governance (ESG) standards to demonstrate responsible corporate behavior and strengthen stakeholder trust.

### **Strategic Risk**

Strategic risk arises when a bank's long-term strategies fail to achieve intended outcomes due to incorrect assumptions, poor decision-making, competitive pressures, or structural market changes. It encompasses risks related to mergers and acquisitions, digital transformation initiatives, expansion decisions, product innovations, or changes in business models.

Strategic misalignment can lead to loss of market share, reduced profitability, or operational disruptions. Rapid technological evolution - such as the rise of fintech firms, blockchain systems, and alternative payment platforms - creates strategic pressure on traditional banks. Effective strategic risk management requires scenario planning, competitive analysis, performance monitoring, and governance oversight at the board level.

### **Systemic Risk and Its Implications**

Systemic risk refers to the likelihood that the failure of one institution or market segment will trigger widespread instability across the entire financial system. This form of risk is driven by interconnectedness, leverage, contagion effects, and market panic. The collapse of Lehman Brothers in 2008 demonstrated how the failure of a single institution can lead to global financial disruption (Brunnermeier, 2009).

Systemic risk management extends beyond the responsibilities of individual banks, requiring comprehensive macroprudential policies and coordinated regulatory actions. Central banks and financial oversight bodies employ tools such as countercyclical capital buffers, systemic risk indicators, and stress testing to monitor vulnerabilities. Banks that pose systemic importance - known as SIFIs or G-SIBs - are subject to stricter requirements due to their potential impact on global financial stability.

### **Interdependence Among Risk Categories**

Although banking risks are classified into distinct categories, they are often interdependent. For example, credit risk deterioration may trigger liquidity shortages, which can then escalate into market instability or reputational damage. Operational failures such as cyber-attacks may simultaneously influence market positions, compliance breaches, and customer confidence. This interdependence highlights the importance of integrated risk management frameworks and enterprise risk management (ERM) systems.

Modern regulatory approaches emphasize comprehensive oversight through risk aggregation, stress testing, and forward-looking assessments. Banks increasingly adopt internal risk cultures that

promote awareness, accountability, and proactive risk identification across all organizational levels. This holistic approach enables institutions to build resilience while navigating complex and unpredictable financial environments.

## **CONCLUSION**

The concept and classification of banking risks constitute the foundational framework for understanding the stability, efficiency, and long-term sustainability of modern financial institutions. As banks operate in an increasingly complex global environment, the diversity and interconnectedness of risks - credit, market, liquidity, operational, legal, strategic, reputational, and others - require a systematic approach to identification, assessment, and management. Proper classification enables institutions to recognize the sources, transmission mechanisms, and potential impacts of risks, allowing them to implement proactive and data-driven risk-mitigation strategies.

A comprehensive understanding of banking risks also highlights the evolving nature of financial threats. Globalization, digital transformation, fintech integration, and macroeconomic volatility continuously reshape the risk landscape, creating new vulnerabilities such as cyber risk, model risk, and ESG-related exposure. Therefore, traditional risk categories must be periodically revised to reflect contemporary developments in financial markets and regulatory frameworks.

In essence, the conceptualization and classification of banking risks not only support effective risk governance within financial institutions but also contribute to broader financial stability at the national and international levels. By establishing a clear taxonomy of risks, banks can strengthen their resilience, enhance transparency, and improve decision-making processes. This underscores the critical role of robust risk-management systems in safeguarding the integrity of the banking sector and ensuring its sustainable contribution to economic growth.

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## **Bank risklərinin anlayışı və təsnifatları**

### **Xülasə**

*Bank sektoru iqtisadi sabitliyin qorunmasında, kapitalın bölüşdürülməsində və maliyyə vasitəçiliyinin effektivliyində həlledici rol oynayır. Bununla birlikdə, banklar qeyri-müəyyənlik şəraitində işlədikləri və müxtəlif xarici və daxili təsirlərə məruz qaldıqları üçün geniş risklərlə qarşılaşırlar. Bu risklər, təsirsiz bir şəkildə müəyyənləşdirildikdə və idarə edildikdə, 2008-ci il global maliyyə böhranı (Acharya & Richardson, 2009) ilə sübut olunduğu kimi ciddi maliyyə böhranına, institusional uğursuzluqlara və ya hətta sistem böhranlarına səbəb ola bilər. Beləliklə, bank riski anlayışı təkcə maliyyə itkisi ehtimalını deyil, həm də bank qurumlarının bazar gözlənilməz hallarına, əməliyyat uğursuzluqlarına və makroiqtisadi qeyri-sabitliyə qarşı daha geniş həssaslığını əhatə edir.*

*Müasir maliyyə sistemlərində tənzimləyicilər, banklardan riskləri ölçülə bilən komponentlərə görə təsnif edən və kapital adekvatlığı tələblərini təyin edən Bazel müqavilələri kimi beynəlxalq standartları qəbul etmələrini tələb edərək etibarlı risk idarəetmə təcrübələrinə ehtiyac olduğunu vurğulayırlar (Basel bank Nəzarət Komitəsi, 2017). Beləliklə, bank risklərinin təsnifatını başa düşmək təkcə uyğunluq üçün deyil, həm də maliyyə qurumlarında strateji qərar qəbuletmə prosesləri üçün vacibdir. Burada bank risklərinin təbiətinə hərtərəfli baxış verilir və elmi ədəbiyyata və beynəlxalq standartlara əsaslanan sistematik təsnifat təqdim olunur.*

**Açar sözlər:** *risk, maliyyə bank, səmərəlilik, maliyyə böhranı, strateji qərar, idarəetmə.*