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MANAGING AND MINIMIZING VARIOUS RISK LEVELS IN THE CURRENT BANKING ENVIRONMENT THROUGH REGULATION AND BANK SUPERVISION: LESSONS FROM POST GLOBAL FINANCIAL CRISIS

Dauda Alusine Kuyateh

Research Scholar, B.K. School of Professional and Management Studies, Gujarat University, Ahmadabad, India

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ABSTRACT

Interestingly, given today's high pace and changing nature of market vulnerabilities, imbalances, and their associated risk factors, banks are inherently prone to excessive losses and failure. Central banks around the world have the statutory mandate, to regulate and supervise banking business as they are custodians of the financial system. Indeed, in the aftermath of the 2008 global financial crisis, productivity growth has staggered in advanced economies despite very easy monetary conditions. This study seeks to evaluate and review the vulnerabilities and imbalances, affecting the banking system, identify and oversee the action needed to address them. Furthermore, as a matter of public policy, restoring depositors' interest, confidence, and trust through regulation and supervision to improve bank effectiveness and efficiency is a financial and economic imperative. Thus, the time has come for a new and changing regulatory framework that would stand the test of times is the only way out to make the banking system effective and efficient.

KEYWORDS: *Bank's Profitability and Performance, Financial Regulation and Supervision, Operational Efficiency, Global Financial Crisis, Risk Management, and Banking Environment*

INTRODUCTION

To effectively manage and minimize risks to an acceptable level coupled with the rising risk levels encountered by banks on a regular and continual basis is a complex and complicating issue, it is vitally important for banking institutions at this current period to maintain credit exposure and one way to do that is by employing a comprehensive risk rating model which would ascertain how much a bank stands to lose in the event of debt/loan default.

Risk management in the banking environment as a matter of fact can be defined as the'' logical development and execution of a plan to deal with potential losses emanating from risk factors.'' Usually, the focus of the risk management practices in the banking industry is to manage an institution's exposure to losses or risk and to protect the value of the assets. Risk management practice is so important that without it, banks would fail on the basis that they won't be able to define their objectives for the future. Take for instance; if an organization defines its objectives without considering the risks, there are possibilities of excessive losses and failures as a result of poor or inefficient risk management strategies, policies, and practices.

Banks are critical components of any modern economy, considering their significance to the financial system and economy as a whole, a bank with a highly leveraged balance sheet and non-performing loans may cause excessive failures and losses which in turn would lead to a decline in profit margin and productivity. For example, the collapse of a large

bank as a result of excessive losses and failures emanating from non- performing loans would have a ripple effect on the profitability and performance of other banks as well.

The call for a proactive and robust global regulatory framework and architecture is anchored on the legislation of new laws, regulations, tools, principles, norms, and standards that would stand the test of time to support the reform agendas and initiatives designed to look into the deepening challenges of bank failures and losses. Risk management in the banking environment is the management of identification, assessment, and prioritization of risks to assess the effectiveness and efficiency of the internal control system and reduce the impact of unexpected events. However, the concept of risk management is a complex and multi-dimensional engagement that would require micro and macro-prudential strategies and analysis to help the global financial system become more resilient, liquid, stable, and less leveraged, and well supervised. The call for a macro-prudential supervision was re-echoed by the Chairman of the US Federal Reserve Bank'' Mr. Ben Bernanke calls for 'powerful regulator'. According to him, a broader approach and strategy were needed to regulate the financial system as a whole, in a holistic way, not just its components. He maintained that in particular, strong and effective regulation and supervision of banking institutions, although necessary for reducing systemic risk, are not sufficient by themselves to achieve this aim.

Conducting a stress test is another important analytical tool to ascertain, evaluate and analyze the degree, type, and level of risk under consideration. It is important to note that the current banking environment is dynamic and changing, so putting in place the right regulatory and institutional framework and policy direction would help improve the financial system. We all know the magnitude in which the financial system is changing very fast with ICT and innovation.

Bank Risks and Their Effects on Profitability

As the banking operations and activities continue to grow and expand, so too the underlying business procedures and processes become complex and complicated. However, achieving the goal of maintaining and sustaining bank performance and efficiency is not an easy task considering the complex nature of risk management and mitigation.

Below are the types of risks involved, their significance, implications and they can be reduced

Table 1 shows According to the Basel Committee publications titled the ''Principle for the Management of Credit Risk,'' It was made very clear in the report that the main cause why banks are frequently experiencing credit risk challenges was a result of inefficient and weak measures, standards, and approaches to comprehensively assess and review asset quality and capital requirement.

Table 1

No.	Type of Risk	Explanation	Implications	How to Reduce Their Effect
1	**Credit Risk**	Credit risk is the inability of a bank borrower or counterparty to honour repayment of principal and interest in due time.	Failure on the part of the borrowers to meet their contractual obligations can result in a high risk to the bank's liquidity position and profitability. However, default risk can result to huge losses and bank failures.	Banks need to effectively assess the risk emanating from the borrower or counterparty and at the same time identify and assess the effects of credit concentrations.
2	**Market Risk**	Market risk occurs in a bank when particular changes take place in equity, interest rates, foreign exchange rates, and commodity prices.	Market risks occur in circumstances where a bank for instance agrees to accept collateral for the loan in return for financial instruments which are exposed to market price volatility in the marketplace.	Since market prices have a significant negative effect on financial performance, banks can reduce such risks by effective and efficient risk management policies and standards which are fundamental to enhancing business insights and growth.
3	**Compliant Risk**	Compliant risk is the failure on the side of banks to follow the prescribed and applicable rules instituted by regulatory bodies. These losses affect the bank day to day operations and activities.	Legal and financial losses occur in a banking system when banks refused to comply with proper regulations, laws, and standards set up by banking authorities.	To effectively manage and appropriately mitigate such risk, banks should as a way of risk mitigation; formulate, regulate and monitor compliance policies and principles in their branches.
4	**Business Risk**	Business risk is an important outcome of credit risk. It arises when a bank is unable to make or record profit for a specific period due to liquidity constraints, business risk is said to arise.	Banks that are experiencing high business risk are left with no option but to be either acquired by other bigger banks or end up going for bankruptcy.	Banks need to adopt and implement the right strategies, and policies that can rescue and save non-performing banks from further collapse.
5	**Security Risk**	Security risk has attracted considerable attention in the current global market, and the issue of cyber security has become a matter of concern because of its negative effect on the industry.	There have been reported cases of hackers using security layers to cause havoc by stealing a huge sum of monies in banks.	With the current technology such as artificial intelligence, machine learning, big data, etc, banks should be able to provide financial products that would yield positive results.
6	**Operational Risk**	Operational risk arises as a result of weak, inefficient, and poor internal controls, processes, policies, procedures, and systems	Effective management of operational risk using the appropriate policies, principles, procedures, and standards are very important as it affects the performance of banks.	Handling the care of operational risks in a more proactive, responsible, and sensitive manner can help to enhance the financial stability of the bank.

Table 1: Contd.,

7	**Reputational Risk**	Reputational risk inflicts huge financial and liquidity loss with diminishing going concern value as a result of reputational damage to the bank and this a damage that would adversely affect revenue and profit if care is not taken	Reputational risk is not good for a bank's growth path and success as it portrays adverse perception that a particular bank is unable to maintain existing healthy business relationships with major stakeholders.	Banks must pay special attention to reputational risk and put in place mechanisms that would boost and foster good relationship with depositors.
8	**Liquidity Risk**	Liquidity risk occurs when a bank is unable to meet its financial obligations due to liquidity and financial challenges	Liquidity risk poses a threat of extreme intensity to the existence, survival, growth, stability, and going concerns of the bank especially when the market is inefficient.	Banks should adhere to the appropriate guidelines prescribed by the Central Bank and put aside a certain amount of capital to cushion the effect of any financial loss.
9	**Systemic Risk**	It is defined as the possibility of events such as shocks, losses, crises, and failures, slow down could occur at the micro-level and further escalate to an unfavourable/negative consequence at the macro-economy level as a whole.	Systemic risk was identified as the main contributor to the global financial crisis in 2008. However, the phenomenon that befalls the big banks, housing, and insurance companies that were seriously hit by systemic risks are the ones considered as ''too big to fail.''	Banks should put in place effective management of systemic risk policies which would have varieties of the portfolio such as fixed income, cash, and real estate so that the regulatory framework be developed.
10	**Systematic Risk**	Systematic risk unlike systemic is part of the total inherent risk which is caused by external factors beyond the control and influence of the bank management.	Systematic risk is unpredictable and not diversified away by holding a significant number of financial assets. The bottom line is, banks experience huge losses due to systematic risk.	Given that systematic risk cannot be easily avoided based on the fact it is unpredictable, however, eliminating it would be a difficult task to do.

Bank Risks and Failures in the Banking Environment

Banking risks have a serious impact on growth and profitability if not adequately handled and managed. Most countries have recognized the need for new regulatory frameworks. Risk management in the banking environment is a financial imperative. The USA and other countries have made strides to put in place tougher laws and strict regulations to minimize losses and failures in the banking environment given the bitter experience of the 2007/2008 financial crisis. As the banking operations and activities increase to enhance bank efficiency and improve profitability, so too, the different types of risks in the banking environment keep increasing. So with that in mind, there comes the increasing need to put in place regulatory controls, guidelines, oversights, and supervisory practices.

Considering the different types and diverse risk factors in the current banking environment which normally hinders operational efficiency and profitability, it is important that risk factors are appropriately handled in order to positively impact the viability of banks (Lyambiko, 2012).

Understanding the current market dynamics which is transformative, it is, therefore, crucial to adopt a regulatory approach that would be more innovative and futuristic. We could still recall the fresh memories of the 2007/2008 global financial crisis and how it troubled the global financial architecture and by extension the global economy (Blankenbury & Palma, 2009).

These authors maintained that an efficient and effective financial system plays a critical role to support economic activity, growth, and development in any country (Akdogu & Umutlu, 2014).

Sinha, et al., (2011) argued that changing regulatory, legislative, and supervisory policies and reforms would be needed to strengthen the current banking system by way of enhancing capital adequacy, asset quality and risk management practices.

Oluwafemi, et al.,(2014) maintained that efficient credit risk management in banks would minimize losses and failures through improved control measures in business processes, systems and procedures which in turn would enhance operational efficiency, credit growth, and profitability.

The rationale behind credit risk management in the banking system is to improve on the underperformance of assets and to ensure that prudent risk management practices and standards are put in place (Oluwafemi, et al., 2014).

Another important consideration in this study is to critically evaluate and examine how advanced economies like the USA where it all started responded to the crisis, what lessons to be learned, and the policy agenda to pursue in order to push forward for a better, stable, efficient, and improved global financial system. Moreover, the centrality and criticality of the banking system should not be overemphasized.

(Ghani, 2013),stressed that the problems of the massive losses and failures during the global financial crisis 2007/2008 were a result of accumulated bad debt, toxic loans, and overleveraged balance sheets in banks. It is therefore important to carefully and critically look at the high-risk exposures of assets and their adverse effects on the long-term growth and success of banks (Tan, et al., 2019).

The crucial thing is that credit risk as a result of possible failure to meet the contractual obligation can significantly weaken the borrowers' capacity for repaying loans (Brown & Moles, 2016).

Fundamentally, in a global financial system that is changing, highly volatile, complex, and risky, the more loans/credits are made available to borrowers or counterparties without due diligence, checks and balances, credit review process, and the credit/financial analysis, the more the risk factors of default increases in the system.

Financial Regulation in the Current Banking System

The critical theme of this argument is how bank regulation and supervision framework can impact profitability. Given the highly regulated nature of the banking environment, regulation and supervision have attracted plenty of attention, discussions, debates, and research around the world.

The topic to a large extent explains why bank regulations continue to be a serious concern these days in the banking domain. As part of the central bank's statutory mandate and responsibility to regulate, supervise and monitor banking activities and operations, they set rules and regulations that would govern the way banks conduct their business activities and operations. However, such rules and regulations are very important as they are meant to protect the interest of depositors', creditors, and investors (Gitara & Mohamed, 2020).

Olson,(2016) in his study investigated banking risks and their effects on the profitability pre and post-global financial crisis 2007/2008, he further highlighted the point that, after those terrible years of bad debts and deterioration in asset quality, there seems to be positive signs and optimism in the banking environment of resuming normal profits and maintaining strong capital adequacy. It is with no doubt that the past lessons learned from the Global Financial Crisis of 2007-2008 have exerted tremendous pressure on banking institutions to take the issue of regulation and supervision requirements seriously as a way to enhancing bank efficiency and improve profitability of banks.The study revealed that regulations and supervisions have an impact on bank's viability (Larch, 2017).

Zeb & Sattar, (2017) noted in their journal article that a banking environment that has a strong regulatory and supervisory framework can facilitate profitability and high efficiency and by extension enhance financial and economic stability.

Recognizing the negative consequences and impact of the 2007-2008 global financial crises, there have been renewed international commitments and efforts to implement reforms and regulatory frameworks that are geared towards strengthening and safeguarding capital requirement, adequacy, and asset quality in the global financial system.

(Pasiouras, et al., 2009), assessed the impact of bank regulation on capital adequacy, supervisory, and market discipline requirements from the perspective of efficiency and performance. They argued that even though bank regulation enhances market discipline it also restricts bank activities to some extent and this has both positive and negative impact on cost and profit efficiency. Their findings revealed that restriction on bank activities due to bank regulation negatively can hurt cost efficiency but positive impact on profit efficiency.

According to (Erdogan, 2016) banking regulation and supervision can impact the bank's profitability and efficiency as well. The finding of the study revealed that there is a positive and significant relationship between capital adequacy and bank performance but hurts asset quality.

The Effort of the U.S Government' To Minimize Bank Risk through Regulation Post Financial Crisis

One very fundamental issue that is worth mentioning is the trade-off between regulation, risk management, and credit growth. Put simply, regulation is a measure to check or regulate excessive risk-taking in banks. But, the bankers see it from the perspective of restricting credit lending in the banking institutions. However, getting the ground running again by embracing regulatory reforms, supervisory requirements and policies is a step in the right direction especially in the USA and Europe where the crisis all started and spilled over to other countries around the world. In pursuit of a global regulatory reform and supervisory framework that would stand the test of time, the USA took the lead by putting into law and legislation the Dodd-Frank and Wall Street Reform and Consumer Protection Act in 2010 which was essentially to enhance prudential guidelines for banks in the areas of liquidity, leverage, capital and Volcker Rule in 2012 to prohibit short- term proprietary trading.

In all of these, banks have now recognized the resultant effect of the global regulatory footprint in the aftermath of the crisis. But what is clear is the fact that there is some progress made, however, on the flip side, some banks see such initiative as a way to impede credit provision and expansion to borrowers.

Many empirical studies have been conducted to establish whether there is a relationship between risk, regulation, and profitability in the banking environment. To a significant extent, the relationship can be positive based on internal control measures put in place to enhance and improve the operating environment.

(Wood & Mc Conney, 2018), further noted that managing banking risks to acceptable levels can have significant impact on the financial performance of the bank. (Apatachioae, 2015), however, maintained that a bank's performance is assessed based on its competitiveness, efficiency, and profitability and most importantly, an understanding of its liquidity position, asset quality, and capital adequacy is critical for its growth and going concerned.

Basel Committee on Banking Supervision

Following the bitter experience of the Global financial Crisis (GFC) in the year, 2007-2008 which took the global financial system by surprise as most of the big and reputable banks, insurance, and mortgage companies in the USA suffered huge financial losses as a result of the accumulated non-performing loans and asset deterioration. These banks because of their overleveraged balance sheet continue to record and report excessive losses. These financial losses were associated with different risk factors which negatively impacts the profitability and performance of the bank. Given the scenario of excess bank failures, the Basle committee was established new standards, procedures, principles, and policies with the aim of improve and enhance the bank's liquidity risk management policies, and the stability of the financial system and environment.

Basel (I)

Basel 1 is defined as a set of global banking regulations developed by the Basel Committee on Banking Supervision framework, specifying a minimum ratio of capital to risk-weighted assets for banking institutions. Moreover, Basel 1 is the first set of a regulation prescribed by Basle committee on banking supervision and being part of the Basle accords. Most importantly, the rationale of the Basel accord was to streamline and standardize the banking practice all over the world. Indeed, Basel 1 guidelines came into force following Mexico's debt crisis and subsequently the suspension of its payments in 1980.

Also, Basel 1 accord did not take into consideration the other types of risks which include; liquidity risk, market risk, interest rate risk, and operational risk.

To conclude, the benefit of Basel 1 to the banking system is that it enhances the management of capital and also helps to improve and increase the capital adequacy ratios of internationally active banks.

Basel (II)

Basel 2 also had some interesting and detailed rounds of discussions and consultations with the view of trying to implement the standardized and fundamental elements of the new and emerging framework. The aim was to encourage the use of internal mechanisms and structures for measuring bank risk and as well as ensure that capital is allocated efficiently. That said Basel 2 was established to roll out the tough prudential guidelines and supervisory responsibilities on one hand and to strengthen the minimum capital requirement on the other.

However, the intention of this new framework Basel 2 was to ensure that the regulatory capital is closely aligned with economic capital in such a way that it would help banks to hold significant amounts of economic capital as a buffer for strategic and reputational reasons.

Basel (III)

The most important thing to know about Basel 3 is that it is a global regulatory mechanism on bank capital, stress testing, and market liquidity risk management. It would interest you to note that Basel 3 was developed in direct response to

weaknesses and shortfalls in financial regulations which were exposed by the Global Financial Crisis of 2007-2008.

Essentially, Basel 3 is a new global regulatory framework for bank capital adequacy and liquidity position which was agreed upon by Basel Committee on Banking Supervision. This global framework was put together as a set of reforms to improve regulation, supervision, and risk management within the banking sector. Being that Basel 3 is an outshoot of both Basle1 and Basle 2 documents, it seeks to improve the banking sector's overall ability to address the fundamental and critical issues in the banking environment such as; financial and economic stress, risk management, and bank transparency.

Crucially, Basel 3 was put together as a result of the deficiencies identified in previous financial regulations as was evidenced in the global financial crisis in 2007-2008. However, the main objective of Basel 3 was to strengthen the bank capital requirements by way of introducing new and robust regulatory requirements that would improve and enhance bank liquidity and leverage.

The Way Forward For an Efficient Banking Environment

Given the current swing of reforms and transformations in the global financial architecture and the lessons learned of the global financial crisis, there is no doubt that in the years to come the financial landscape and environment would dramatically change. The issue of bank risk management should be a top priority in the bank's strategic planning because it would help to foster close collaborations, de-biased decision making, managing multiple risk types.

The significance for adopting a new and changing regulatory framework and the need for banks to complying with the current regulations is more vital and useful. I think the role of banks by way of fulfilling customer expectations would clearly be defined as a key contributor in achieving their bottom lines.

Another critical turning point is that of the risk function. Risk function is a key differentiating factor that can lead a bank to success or failure depending on how well the risk levels and factors are managed and mitigated.

CONCLUSIONS

Based on the ongoing discussions of the past crisis and what should be done next in the event of any other crisis, the Global Financial Crisis 2007/2008 revealed a lot which has necessitated the need for banks to put their house in order by way of doing the right things within the regulatory framework set up by Basel Committee on Banking Supervision.

However, two issues came out in our findings; (1) building a strong and robust regulatory framework around asset quality and minimum capital requirements and (2) and employing the appropriate tools, techniques, and methodologies to identify, assess, evaluate, monitor, and manage risks in the banking environment. Studies have indicated that when the issues of asset quality and capital requirements are taken care of through micro and macro-prudential guidelines, norms, supervisory measures and principles, overleveraged balance sheets and non-performing loans would be reduced.

Furthermore, risk management and mitigation is a complex phenomenon but a financial imperative. And thus, the need for a comprehensive approach to assessing the financial standing and credit worthiness of borrowers. It is against that background that an effective credit analysis and rating is considered essential signalling early warning and showing a red flag that something needs to be done.

Banks that operate under severe risk conditions are likely to bear the huge loss. However, a robust, proper, and thorough evaluation and assessment mechanism is needed to identify, assess, measure, analyze and minimize risk to an acceptable level.

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