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Risk Management Strategies in Financial Institutions in Nigeria: the Experience of Commercial Banks

[1]Stephen I. Dugguh, Ph.D, [2]Joseph Diggi, MSc.

[1]*Department of Accounting and Business Administration, Federal University, Kashere, Gombe, Nigeria*
[2] *# 1 Walabai Close, Keffi-Abuja Expresswa, Federal Capital Teritory, Abuja, Nigeria*

ABSTRACT

The desire by financial service institutions especially commercial banks to ensure stable and successful business has brought about the restructuring, reviewing and updating of different strategies. One among these strategies is risk management. Researchers, financial institutions authorities and analysts have identified and warned that some of the major causes of bank distresses include weak capitalization, poor management, weak internal controls, poor corporate governance and most importantly, poor risk management practices. That is where the problem of this paper lies. Therefore, the objective of this study is to review the strategies adopted by financial service institutions in Nigeria with particular reference to commercial banks with a view of proffering solutions for a more effective, efficient, and profitable operations. The paper reviews relevant literature on risk management, strategies and reduction. It found that risk is one of the greatest challenges confronting commercial banks in recent time in Nigeria. The paper recommends ways of making these strategies more effective and urges management to give top priority in hedging and managing risks in commercial banks.

Keywords: Risks, Commercial Banks, Profitability, Performance, Strategies, Management.

INTRODUCTION

Banks are germane to economic development through the financial services they provide. Their intermediation role can be said to be a catalyst for economic growth. The efficient and effective performance of the banking industry over time is an index of financial stability in any nation. The extent to which a bank extends their operation to the public for productive activities accelerates the pace of a nation's economic growth and its long-term sustainability (Kolapo, Ayeni & Oke, 2012). In the 21st century business environment is added multifaceted and intricate than ever. The majority of businesses have to trade with uncertainties and qualms in every dimension of their operations. Without a doubt, in the present-day's unpredictable and explosive atmosphere all the banks are in front of a hefty risks like: credit risk, liquidity risk, operational risk, market risk, foreign exchange risk, and interest rate risk, along with others risks, which may possibly intimidate the survival and success of the bank's Corporate Performance.

The Nigerian banking industry has been strained by the deteriorating quality of its risk related assets as a result of the significant dip in equity market indices, global oil prices and sudden depreciation of the naira against global currencies (BGL Banking Report, 2010).The poor quality of the banks' loan assets hindered banks to extend more credit to the domestic economy, thereby adversely affecting economic performance. This prompted the Federal Government of Nigeria through the instrumentality of an Act of the National Assembly to establish the Asset Management Corporation of Nigeria (AMCON) in July, 2010 to provide a lasting solution to the recurring problems of non-performing loans that bedeviled Nigerian banks (Kolapo, et al, 2012).

In the last few years, Nigerian banking industry suffered an historic retrogressive trend in both profitability and capitalization. Just 3 out of 24 banks declared profit, 8 banks were said to be in 'grave' situation due to capital inadequacy and risk asset depletion; the capital market slummed by about 70 percent and most banks had to recapitalize to meet the regulatory directive (CBN, 2010). This drama in the banking sector eroded public confidence in banking and depositors funds

Address for correspondence:

sdugguh@fukashere.edu.ng

aggregately dropped by 41% in the period. Possibly due to financial liberalization and globalization, the fact is there has been a reckless abandonment of the essentials of managing risk in times of economic boom and recession; the volatility of bank earnings has been under-rated by bank managements. The central monetary authorities also impacted negatively on stability of the sector. The auditing exercise was a very good one but the sanctity and policy implementation mode was bad considering the nature of the Nigerian economy.

Basically, bank objectives revolve around 3 directions: profitability, growth in asset and customer base. Aremu, Suberu, & Oke (2010) pointed out that the major problem of bank management is the mis-prioritization of short term goals over its long term objectives. While the profitability centres on the quality of short term reprievable assets and liabilities, net worth expansion which is the equity capital, is a function of total asset and liability. In Nigeria, it has been observed that most bank managers have focused more on profitability (which usually is a short term objective), with little attention on risk managing the quality of assets which has better impact on the long term sustainability of a financial institution. The risks that are faced by businesses can be categorized into financial and non-financial risks. Both of these types of risks are very vital in order to safely run any business. Sadaqat, Akhtar, & Ali, (2011) also scrutinizes credit risk having its financial nature and operational risk with its non-financial nature in context to Nigerian Commercial Banks, as financial market of Nigeria is among volatile markets of the world which is filled with anonymity and escapade performances.

The recent economic crisis has focused attention on risk management, but managing risk is all about achieving objectives (Woods, Kajüter, and Linsley, 2008; Van der Stede, 2009). Senior managers in particular, are expected to build sustainable performances: create value at acceptable risk levels over time (Calandro and Lane, 2006). To this end, they should be clearly aware of the multiple sources and types of risks (CIMA, 2007). A stronger focus on risk in performance reports addressed to senior managers can address such expectation. Incorporating risk into performance management processes can foster a better understanding of the overall organisational risk exposure and improve business results.

The way in which senior managers are made aware of risks via top management reporting is however an open ground where different professions and processes may find a role. On the one hand, the reporting of high level risk information is considered a constituent element of enterprise-wide risk management (ERM) frameworks. These attempts to provide an overview of crucial business risks, integrating traditional, function-specific risk management efforts, for example labour safety and information system security. This reporting can include a range of different information (Lam, 2006): qualitative information such as objectives at risk, audit findings and escalation of particular events or quantitative data such as early warning indicators, key risk indicators (KRIs) and financial risk measures, for example value at risk (VaR).

On the other hand, it is argued that innovative performance management frameworks may contribute to foster senior managers' ability to oversee business risks (CIMA, 2007). In fact, frameworks such as the Balanced Scorecard (BSC) try to overcome the shortcomings of traditional accounting indicators by means of a balanced set of non-financial performance measures. These allow an early detection of weak signals from the environment and provide a more timely and long-term oriented view of the business (Kaplan and Norton, 1992, 1996, 2001). The use of such frameworks can help signal that some risks related to an item exist and will eventually cause poor financial performances.

STATEMENT OF THE PROBLEM

The Nigerian Commercial Banking industry has experienced series of problems right from the early 30s down to the middle of the first decade of the new millennium. In 1930 for instance, 21 banks failed. In 1958 when the Central Bank of Nigeria was founded, about 9 banks failed. Still in 1989, about 7 banks failed. In 2006, the numbers of banks were reduced to 24 from 87. As if it is not enough, the number continued to fluctuate from 25 to 24 and so on. The most recent record of banks failure in Nigeria was 2011 when 3 banks were acquired by the Asset Management Corporation of Nigeria (AMCON). Perhaps this problem is subject to recurrence. The question is: does it mean that these banks are not managing their risks at all; or is it that they are managing them poorly?

It is bewildering indeed when one begins to examine the Nigerian scenario of the financial crises; it is incomparable and sometimes very strange! Another question that comes to mind is why it is difficult for these Banks to find a lasting solution to this seeming customary problem in the industry. The study therefore attempts to assess the risk management strategies obtainable in the commercial Banks in Nigeria. The consequences of bank failures are numerous and very unpalatable, not only to the depositors but also the investors, the general banking public and indeed, the entire economy. The regulators and operators have also not had it easy when financial institutions collapse. Bank failures, in general, impair financial intermediation and efficient allocation of resources. They retard individual well-being and economic progress.

PAPER OBJECTIVE

The objective of this paper is to review the strategies adopted by financial institutions in dealing with risk with particular reference to commercial banks with a view of proffering solutions for a more effective, efficient and profitable operations in the banking industry in Nigeria.

LITERATURE REVIEW AND CITATIONS

The global economic meltdown caused by the subprime mortgage crisis in the US in 2007 and its adverse effect on financial markets and participants in the financial industry worldwide has triggered a capital management crisis in most financial institutions, especially the commercial banks. In market-based countries where capital market dominates economic activities, banks have suffered a severe shock in their capital and liquidity status due to the unanticipated downturn in the financial market and a credit crunch experience in the financial industry. This made a number of banks go illiquid and some even closed down operations (Omotola, Roya & Safoura 2012). It is a common practice that profit-maximising firms, including banks, consider operational miscalculation which could be as a result of macroeconomic risks, such as the effect of interest rates, inflation or even business cyclicality.

Further, microeconomic risks like new competitive threats are inevitable and should be dealt with adequately. Bank-wide issues such as technological failures, commercial inefficiency of a supplier or customer, political manipulation, X-inefficiency and natural disaster are possible risks faced by banks and other financial institutions. In addition, the debacle in financial and non-financial sector as a result of the contagious subprime crisis indicates a strong need for risk management. According to Pyle (1997), financial misadventure is not really a new phenomenon but the rapidity of economic downturn caused by this has nec essitated the need for integrating an efficient risk management system.

The past few decades has witnessed growing interest of experts in the field. While some writers have instituted an argument of what kind of risk management model should be adopted by deposit taking financial institutions, others have suggested more stringent regulatory options. Risk management involves risk identification, risk measurement (and quantification), and mitigation. However, a point to note here is the perception of what constitutes risk to a firm may differ from institution to institution, time to time, and industry to industry.

CONCEPTUAL CLARIFICATIONS

Risk

Risk is part of life. Avoiding all risk would result in no achievement, no progress and of course, no reward. Ordinarily, risk is associated with the likelihood of a negative outcome. However, in management, risk is the chance that an investment's actual return will be different than expected. A fundamental idea in finance is the relationship between risk and return on investment. It implies future uncertainty about deviation from expected earnings or expected outcome and measures the uncertainty that an investor is willing to take to realize a gain from an investment. There are different types of risks: liquidity risk, sovereign risk, insurance risk, business risk, default risk and so on (The Economic Times, 2015).

From the above, it could be noted that there are different definitions of risk for each of several applications. The widely inconsistent and ambiguous use of the word is one of several current criticisms of the methods to manage risk (Douglas, 2009). The ISO 31000 (2009) /ISO Guide 73 definition of risk is the 'effect of uncertainty on objectives'. In this definition, uncertainties include events (which may or not happen) and uncertainties caused by a lack of information or ambiguity. This definition also includes both negative and positive impacts on objectives. The ISO 31000:2009 covers information security management measurements, generally known as security metrics.

The standard is intended to help organizations measure, report on and systematically improve the effectiveness of their information security management systems. It improves guidance on the development and use of measures and measurement in order to assess the effectiveness of an implemented information security management system (ISMS) and controls or groups of controls, as specified in ISO/IEC 27001. This would include policy, information security risk management, control objectives, controls, processes and procedures, and support the process of it revision, helping to determine whether any of the ISMS processes or controls need to be changed or improved. The Standard has the following key sections: information security measurement overview, management responsibilities, measures and measurement development, measurement operations, data analysis and measurement result reporting, information security measurement program evaluation and improvement.

The Institute of Risk Management (https://www.theirm.org/about/r) defines risk as the combination of probability of an event and its consequence. Consequences could range from negative to positive. All organizations have objectives at strategic, tactical and operational levels and anything that makes achieving these objectives uncertain is termed as risk. Risk is also defined in terms of probability of an event and its consequences. Cohen (1982) posits that risk is simply mixing courage and common sense. In another definition, risk is regarded as future issues that can be avoided or mitigated, rather than present problems that must be immediately addressed. The simple fact is that risk is always a probability issue. Possibility is a binary condition – either something is possible, or it's not: 100 percent or 0 percent. Probability reflects the continuum between absolute certainty and impossibility. The key thing to keep in mind is that establishing probabilities is not the same thing as foretelling the future. OHSAS (Occupational Health & Safety Advisory Services) defines risk as the product of the probability of a hazard resulting in an adverse event, times the severity of the event. The ISO 3100 view of risk is appropriate for this paper.

Risk Management

Risk management is a systematic process of understanding, evaluating and addressing risks to maximize the chances of objectives being achieved and ensuring organizations, individuals and communities are sustainable. It also enables the organization to be aware of new possibilities. In effect, risk management requires an informed understanding of relevant risks, an assessment of their relative priority and a rigorous approach to monitoring and controlling them. It is indeed the practice of identifying potential risks in advance, analyzing them and taking precautionary steps to reduce or curb the risk. In finance and business term, when an organization makes an investment decision, it exposes itself to a number of financial risks. The quantum of such risks depends on the type of financial instrument. The financial risks might be in form of high inflation, volatility in capital markets, recession and bankruptcy and so on. In order to minimize and control the exposure of investment to such risks, bank managers and investors resort to the practice of 'risk management'.

Tsevisani (2007) holds the view that the interaction between human factors and tangible aspects of risk highlights the need to focus closely on human factors as one of the main drivers for risk management: a change driver that comes first of all from the need to know how humans perform in changing environments and in the face of risks.

RISK MANAGEMENT STRATEGIES

Risk management strategies are measures employed by banks to avoid or minimize the adverse effect of risk. This includes the identification, analysis, assessment, control and avoidance, minimization or elimination of unacceptable risks. As a strategy, an organization may use risk assumption, risk avoidance, risk retention, risk transfer or any other strategy (or combination of strategies) in effective management of future events. Therefore a sound risk management framework is crucial for commercial banks to enhance their profitability and guarantee survival. The key principles in credit risk management process are sequenced as follows: establishment of a clear structure, allocation of responsibility, prioritized processes, discipline and responsibilities should be clearly communicated and accountability assigned. Specifically, the strategies for hedging risk include but not limited to:

Risk Derivatives

This provides banks with an approach which does not require them to adjust their loan portfolio. Credit derivatives provide banks with a new source of fee income and offer banks the opportunity to reduce their regulatory capital (Shao & Yeager, 2007). The commonest type of credit derivative is credit default swap whereby a seller agrees to shift the credit risk of a loan to the protection buyer. Recent innovations in credit derivatives markets have improved lenders' abilities to transfer credit risk to other institutions while maintaining relationship with borrowers (Marsh, 2008).

Credit Securitization

It is the transfer of credit risk to a factor or insurance firm and this relieves the bank from monitoring the borrower and fear of the hazardous effect of classified assets. This approach insures the lending activity of banks. The growing popularity of credit risk securitization can be put down to the fact that banks typically use the instrument of securitization to diversify concentrated credit risk exposures and to explore an alternative source of funding by realizing regulatory arbitrage and liquidity improvements when selling securitization transactions (Michalak & Uhde,2009). A cash collateralized loan obligation is a form of securitization in which assets (bank loans) are removed from a bank's balance sheet and packaged (tranched) into marketable securities that are sold on to investors via a special purpose vehicle (SPV) (Marsh,2008).

Compliance to Basel Accord

The Basel Accord is international principles and regulations guiding the operations of banks to ensure soundness and stability. The Accord was introduced in 1988 in Switzerland. Compliance with the Accord means being able to identify, generate, track and report on risk-related data in an integrated manner, with full audit ability and transparency and creates the opportunity to improve the risk management processes of banks. The New Basel Capital Accord places explicitly the onus on banks to adopt sound internal credit risk management practices to assess their capital adequacy requirements (Chen and Pan, 2012).

Adoption of a Sound Internal Lending Policy

The lending policy guides banks in disbursing loans to customers. Strict adherence to the lending policy is by far the cheapest and easiest method of credit risk management. The lending policy should be in line with the overall bank strategy and the factors considered in designing a lending policy should include; the existing credit policy, industry norms, general economic conditions of the country and the prevailing economic climate (Kithinji,2010).

Credit Bureau

This is an institution which compiles information and sells this information to banks as regards the lending profile of a borrower. The bureau awards credit score called statistical odd to the borrower which makes it easy for banks to make instantaneous lending decision. Example of a credit bureau is the Credit Risk Management System (CRMS) of the Central Bank of Nigeria (CBN).

Profitability Performance

The most common measure of bank performance is profitability. Profitability is measured using the following criteria: Return on Assets (ROA) = a net profit/total asset shows the ability of management to acquire deposits at a reasonable cost and invest them in profitable investments (Ahmed, 2009). This ratio indicates how much net income is generated per £ of assets. The higher the ROA, the more the profitable the bank is. Return on Equity (ROE) = net profit/ total equity. ROE is the most important indicator of a bank's profitability and growth potential. It is the rate of return to shareholders or the percentage return on each £ of equity invested in the bank. Cost to Income Ratio (C/I) = total cost /total income measures the income generated per ₦ cost. That is how expensive it is for the bank to produce a unit of output: the lower the C/I ratio, the better the performance of the bank.

Liquidity Performance

Liquidity indicates the ability of the bank to meet its financial obligations in a timely and effective manner. Samad (2004:36) states that ''*liquidity is the life and blood of a commercial bank*''. Financial liabilities are attracted through retail and wholesale distribution channels. Retail generated funding is considered less interest elastic and more reliable than deposits attracted from wholesale distribution channels (Thygerson, 1995). The following ratios are used to measure liquidity:

Liquid Assets to Deposit-borrowing ratio (LADST) = liquid asset/customer deposit and short term borrowed funds. This ratio indicates the percentage of short term obligations that could be met with the bank's liquid assets in the case of sudden withdrawals.

Net Loans to Total Asset ratio (NLTA) = Net Loans/Total Assets NLTA measures the percentage of assets that is tied up in loans. The higher the ratio, the less liquid the bank is.

Net Loans to Deposit and borrowing (NLDST) = Net loans/total deposits and short term borrowings. This ratio indicates the percentage of the total deposits locked into non-liquid assets. A high figure denotes lower liquidity.

Asset Credit Quality (Credit Performance)

While it is expected that banks would bear some bad loans and losses in their lending activities, one of the key objectives of the bank is to minimize such losses (Casu, Molyneux, & Girardone, 2006). Credit performance evaluates the risks associated with the bank's asset portfolio i.e. the quality of loans issued by the bank. Several ratios can be used for measuring credit quality however, not all information on the loans is always available. Non-performing loans is not available for all banks therefore this paper use the following ratio:

Loan loss reserve to gross loans (LRGL) = Loan loss reserve/gross loans. This ratio indicates the proportion of the total portfolio that has been set aside but not charged off. It is a reserve for losses expressed as a percentage of total loans.

Ratio Working Capital to Total Asset measures the net liquid assets (i.e. current assets less current liabilities) of a company to its total capitalization.

Ratio Retained Earning to Total Assets measures the cumulative profitability over time of a company. Infant company would show an adverse RA/TA ratio because it has no cumulative profits overtime.

Ratio Earnings before Interest and Tax to Total Assets measures the true productivity of the company's assets. It is a very significant ratio for studies involving business failure.

Ratio of Market Value of Equity to Total Liabilities shows how much the firm's equity can reduce in value before the liabilities exceed the assets and the company becomes insolvent. Equity involves the combination of market value of preference and common shares.

Ratio Gross Earning to Total Assets measures the firm's assets utilization. This ratio measures the management capacity in dealing with competitive conditions.

METHODOLOGY

As earlier stated, the paper is a review. Relevant literature: books and journals on risk, risk management and reduction were used for findings. Of particular note were those of Aremu, Suberu & Oke (2010), CIMA (2007), Omotola, Rayo & Safoura (2012) and ISO 31000 (2009). This method allows for investigation of risk management strategies that are developed by different specialists and experts, Findings, discussions and conclusion were drawn on the basis of the review of these literature and documents.

8.0 LITERATURE FINDINGS

Risks are serious threat to the performance of banks; therefore various researchers have examined the impact of certain risks on banks in varying dimensions which is in line with the finding of this study.

One of the major findings in this study is that commercial banks in Nigeria do actually employ and or adopt viable risk management strategies. These strategies are not static because they are being reviewed and being updated from time to time in line with the unavoidable constant and frequent changes. The most common risk management strategies found in the industry as discovered in this study are those risk management blueprints frame worked by certain risk-expert organizations such as the Basel Accord I & II, International Standard Organisation and Central Bank of Nigeria.

Risk and performance are related, but the combination of risk and performance information into a single instrument is not always the most feasible solution to reach alignment. The way in which risk is related to performance management is based around a variety of organizational elements that may inhibit or conversely facilitate the integration of risk and performance management processes. For instance, the presence of a different periodicity of risk and performance reporting may limit their integration.

Secondly, the paper finds that the presence of a clear cut strategy that serves as a reference point for both risk and performance targets may foster alignment. Risk is often implicitly related to performance management. Performance management tools can provide risk information without much additional efforts. For instance, performance reports can contribute to develop an awareness of emergent issues by highlighting performances that are changing unexpectedly. In certain areas, for example Health and Safety (H&S), KPIs can become good measures around risk. Trends in the number of incidents (or near misses) can be analyzed to understand whether the business is becoming more or less risky.

Thirdly, as may be the case with other organizations, many commercial banks now allocate large amount of money and time in developing risk associated with their business and investment dealings. A key component of the risk management process therefore is risk assessment: determining the risk surrounding a bank or any investment. This will assist banks in hedging and minimizing risks.

CONCLUSION

We now live in a world of uncertainty. Nigerian commercial banks have sustained and are most likely to suffer more penury if they refuse to give risk management a top priority consideration. In this study, it has been found that commercial banks have not been implementing their risk management strategies properly which highly contributed to the financial dilemma experienced by the industry. The risk management strategies adopted would have facilitated a sharp and stable improvement of profitability, growth in asset and customer supposed their risk were well implemented.

RECOMMENDATIONS

Based on the review and literature findings, the paper recommends that:

Bank managers should regard risk management as an integral element of corporate strategy and seek the support of top management on one hand. Top management on the other hand should support managers in implementing strategies for risk reduction. Risk factors should be assessed from time to time and appropriate strategy embarked upon to reduce the risk so identified for effective, efficient and profitable performance of commercial banks in Nigeria. In this case a sound internal lending policy and strict adherence to Central Bank of Nigeria Risk Management Guidelines becomes imperative.

Further, consultants and risk management specialist should be consulted from time to time to assess the type of risk and timely steps should be taken to avoid future losses to enhance profitability in the banking industry.

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