



# Credit Risk Management as an Investment Risk Strategy and Its Implications for Bank Stability

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## Abstract

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This study conceptually examines the role of credit risk management as an investment risk strategy and its implications for bank stability. Credit provision represents a core form of investment decision-making in the banking sector, exposing banks to significant risk–return trade-offs. Among these risks, credit risk is dominant because it directly affects asset quality, liquidity, and financial resilience. This study adopts a qualitative Systematic Literature Review (SLR) approach to synthesize recent academic and policy-oriented literature on credit risk, non-performing loans, and financial stability. By integrating findings from banking, financial stability, and risk management research, the review explains how credit risk management practices such as credit quality monitoring, portfolio diversification, and risk-taking control function as mechanisms for mitigating investment risk in banking. The findings indicate that effective credit risk management is central to preserving the quality of banks' investment portfolios and strengthening resilience to economic shocks. Conceptually, the study highlights that credit risk management should be understood not only as a risk control function but also as a strategic component of stability-oriented banking investment decision-making.



## **1. Introduction**

Banks play a central role in modern financial systems through their intermediation function and capital allocation activities that support investment and economic growth. In this context, credit provision is not merely an operational banking function but also represents a form of investment decision-making, as banks allocate funds with the expectation of generating future returns. Each credit decision inherently involves a certain level of risk, making banks' ability to manage these risks a key determinant of operational stability and long-term financial sustainability.

The deterioration of credit quality, commonly reflected in rising non-performing loans (NPLs), is widely recognized as a major source of pressure on banking performance. When credit quality weakens, banks face increased provisioning requirements, declining profitability, and liquidity pressures, which may ultimately constrain their capacity to extend new credit and support long-term investment expansion (Khan et al., 2020)). As a result, credit risk emerges as a critical factor influencing bank stability.

Credit risk becomes increasingly significant when banks operate in environments characterized by market volatility and economic uncertainty. Macroeconomic stress and global liquidity disruptions may weaken banks' intermediation functions and increase the vulnerability of the financial system as a whole (Harun & Gunadi, 2022). Under such conditions, the accumulation of credit risk affects not only individual banks but also generates potential systemic implications.

In response to these challenges, credit risk management should not be viewed solely as an internal control mechanism. Financial literature emphasizes that managing credit risk constitutes an integral component of financial stability strategies aimed at limiting risk accumulation and preserving the resilience of the banking system over the long term (Berisha et al., 2023). Accordingly, credit risk management is highly relevant to be examined as an investment risk strategy that supports bank stability in dynamic economic environments. therefore, this study aims to clarify the strategic role of credit risk management as an investment risk strategy and to synthesize its implications for bank stability from a conceptual and theoretical perspective.

From a methodological perspective, this study adopts a qualitative and conceptual orientation. Rather than testing empirical relationships or estimating econometric models, the analysis synthesizes existing theoretical, empirical, and policy-based literature to clarify how credit risk management operates as an investment risk strategy within the banking sector. This approach is particularly relevant given the extensive but fragmented body of research on credit risk, non-performing loans, and financial stability.

Accordingly, this study employs a qualitative Systematic Literature Review (SLR) to integrate insights from recent peer-reviewed studies and authoritative institutional reports. By focusing on conceptual patterns and convergent findings, the study aims to strengthen theoretical understanding and provide a structured synthesis that informs banking stability research and strategic decision-making.

From an investment perspective, credit allocation exposes banks to long-term risk–return trade-offs that are closely linked to asset quality and financial resilience. Unlike other forms of financial investment, bank lending is inherently illiquid and highly sensitive to macroeconomic conditions, borrower behavior, and regulatory constraints. Consequently, ineffective credit risk management may transform lending activities from productive investment channels into sources of financial fragility. This condition becomes particularly critical during periods of economic stress, when deteriorating credit quality may rapidly erode capital buffers and undermine confidence in the banking system. Therefore, understanding credit risk management as a strategic investment risk framework is essential for explaining how banks sustain stability while pursuing long-term performance objectives.

## **2. Literature Review**

### **2.1. Credit Risk and Bank Stability**

The literature consistently identifies credit risk as a primary determinant of bank stability due to its direct impact on asset quality, liquidity, and financial resilience. Elevated levels of credit risk weaken banks' balance sheets and increase vulnerability to financial distress. In particular, the accumulation of non-performing loans (NPLs) has been widely recognized as a central channel through which credit risk undermines banking stability.

Prior studies highlight that rising NPLs constrain banks' profitability and liquidity by increasing provisioning requirements and reducing income-generating capacity. These pressures limit banks' ability to extend new credit and support

productive investment activities, thereby weakening their intermediation role within the financial system (Khan et al., 2020). From a stability perspective, persistent deterioration in credit quality may amplify financial fragility and heighten systemic risk.

Beyond firm-level effects, credit risk also generates broader macro-financial implications. Policy-oriented and conceptual research emphasizes that high NPL ratios may restrict credit supply, intensify downturns in the financial cycle, and transmit stress across the banking system (Harun & Gunadi, 2022). These findings underscore that credit risk management is not only a microprudential concern but also a macroprudential priority for safeguarding financial stability.

## **2.2. Credit Risk and Bank Stability**

Credit risk management is widely conceptualized as a structured process involving risk identification, measurement, monitoring, and control. Contemporary literature increasingly emphasizes that credit risk management should be embedded within banks' strategic decision-making frameworks rather than treated as a purely operational control function.

From an investment perspective, lending activities represent long-term risk–return commitments that expose banks to uncertainty related to borrower behavior, macroeconomic conditions, and market volatility. Ineffective credit risk management may transform lending from a productive investment activity into a source of financial instability. Accordingly, scholars argue that credit risk management functions as an investment risk strategy aimed at preserving asset quality and sustaining financial resilience (Berisha et al., 2023)

International regulatory and governance-oriented studies further stress that integrating credit risk management into overall risk governance structures enhances banks' capacity to withstand shocks and maintain stability (Zan, 2024). This strategic orientation highlights the dual role of credit risk management as both a risk mitigation mechanism and a stability-supporting investment framework.

### **2.3. Credit Monitoring, Diversification, and Risk-Taking Behavior**

One of the core components of credit risk management emphasized in the literature is continuous credit quality monitoring. Effective monitoring systems enable early detection of potential asset deterioration, allowing banks to implement corrective measures before risks materialize into significant losses. Prior research suggests that robust monitoring practices contribute to reduced performance volatility and improved banking stability (Chandra et al., 2024).

In addition to monitoring, credit portfolio diversification is recognized as a key strategy for mitigating concentration risk. By distributing credit exposure across sectors and borrower categories, banks can reduce vulnerability to sector-specific shocks and enhance long-term resilience. Empirical and conceptual studies indicate that diversified credit portfolios are associated with lower risk exposure and stronger bank stability (Nguyen & Nguyen, 2024).

The literature also identifies bank risk-taking behavior as an important transmission channel linking credit risk to financial stability. Market conditions and institutional incentives may encourage excessive risk-taking, amplifying credit exposure and increasing systemic vulnerability. Several studies emphasize that

controlling excessive risk-taking is essential for maintaining stability in the banking system (Wahinya et al., 2023).

### **2.3. Credit Monitoring, Diversification, and Risk-Taking Behavior**

Recent studies highlight that credit risk does not operate in isolation but interacts with other forms of financial risk, including market risk and global liquidity pressures. During periods of heightened economic uncertainty, unmanaged credit risk may intensify systemic stress and accelerate instability transmission across financial markets.

Consequently, the literature increasingly advocates for an integrated risk management approach that aligns credit risk management with broader risk governance frameworks. Such integration enhances banks' capacity to manage interconnected risks and strengthens overall financial stability (Nwachukwu et al., 2021; Nguyen & Nguyen, 2024). This integrated perspective reinforces the conceptual positioning of credit risk management as a central pillar of stability-oriented banking strategies.

## **3. Methods**

This study adopts a qualitative Systematic Literature Review (SLR) approach to examine the role of credit risk management as an investment risk strategy and its implications for bank stability. The SLR approach is selected because the objective of the study is to develop a conceptual synthesis and theoretical understanding based on existing academic literature, without collecting or testing new empirical data. The

literature review focuses on recent and relevant studies that address credit risk, non-performing loans, investment risk, and financial stability within the banking sector.

The literature search was conducted systematically using widely recognized academic databases, including Google Scholar and reputable journal publisher platforms. Peer-reviewed journal articles and internationally recognized institutional reports were selected based on their relevance to credit risk management and bank stability, with priority given to publications from the last five years, while allowing limited inclusion of seminal works. The selected studies were analyzed using qualitative thematic synthesis to identify key conceptual patterns related to credit risk dynamics, investment risk mitigation, and banking stability, without applying quantitative measurement or empirical hypothesis testing.

## **4. Results**

### **4.1. Overview**

The Results section presents a thematic synthesis of the selected literature based on the Systematic Literature Review approach. The findings are articulated as conceptual patterns that explain how credit risk management operates as an investment risk strategy and its implications for bank stability. Given the qualitative and conceptual nature of this study, the Results do not include empirical testing but instead provide literature-based thematic conclusions.

**Table 1.** Synthesized Results on Credit Risk Management, Investment Risk, and Bank Stability

| No. | Synthesized Result                                                                                                    | Conceptual Dimension                       | Key Supporting Literature |
|-----|-----------------------------------------------------------------------------------------------------------------------|--------------------------------------------|---------------------------|
| 1   | Credit risk is a primary determinant of bank stability as it directly affects asset quality and financial resilience. | Credit risk → Bank stability               | (Adem, 2022)              |
| 2   | Rising non-performing loans weaken bank profitability and liquidity, constraining lending and investment capacity.    | NPL → Performance<br>→ Investment capacity | (Khan et al., 2020)       |
| 3   | Effective credit risk management serves as a mechanism for mitigating investment risk in banking.                     | Credit risk management → Investment risk   | (Berisha et al., 2023)    |
| 4   | Continuous credit quality monitoring enables early detection and control of asset quality deterioration.              | Credit monitoring                          | (Nwachukwu et al., 2021)) |
| 5   | Credit portfolio diversification reduces concentration risk and enhances banks' resilience to sectoral shocks.        | Credit diversification                     | (Nguyen & Nguyen, 2024)   |
| 6   | Bank risk-taking behavior mediates the relationship between credit risk and financial system stability.               | Risk-taking channel                        | (Wahinya et al., 2023)    |
| 7   | Credit risk interacts with market risk and global liquidity pressures, amplifying systemic implications if unmanaged. | Credit–market risk interaction             | (Nguyen & Nguyen, 2024)   |

#### 4.1. Overview

The synthesis indicates that credit risk is consistently positioned in the literature as a key factor influencing bank stability. When credit quality deteriorates, banks face pressures on asset quality and financial resilience, increasing their vulnerability to instability.

The literature further confirms that rising non-performing loans directly reduce bank profitability and liquidity. These conditions constrain banks' ability

to extend new credit and limit opportunities for investment expansion, positioning credit risk as a primary constraint on banking investment performance.

Subsequent findings highlight the strategic role of credit risk management as an investment risk mitigation tool. Practices such as credit monitoring, portfolio diversification, and the control of excessive risk-taking enable banks to manage risk exposure more effectively and maintain operational stability.

Additionally, the results demonstrate that credit risk does not operate independently but interacts with market risk and global liquidity pressures. This interaction amplifies the systemic implications of credit risk, particularly during periods of economic uncertainty. Consequently, the integration of credit risk management into broader risk management frameworks emerges as a central theme in the analyzed literature.

## **5. Discussion**

The findings of this study position credit risk management as a strategic investment risk framework rather than a purely operational control mechanism. The synthesized literature demonstrates that credit risk fundamentally shapes banks' investment capacity by influencing asset quality, liquidity conditions, and financial resilience. From this perspective, managing credit risk is inseparable from managing the long-term risk–return profile of banking investment activities.

Rising non-performing loans represent the primary channel through which credit risk affects bank stability. As NPL levels increase, pressures on profitability and liquidity constrain banks' lending and investment capacity, thereby limiting long-

term growth potential. This interpretation confirms that credit risk functions as a major impediment to banking investment performance and amplifies stability vulnerabilities, as reflected in financial stability and banking crisis literature (Adem, 2022).

The Discussion further emphasizes the role of credit risk management as an investment risk mitigation strategy. Practices such as continuous credit monitoring, portfolio diversification, and the regulation of excessive risk-taking not only reduce potential credit losses but also preserve intermediation functions and financial stability. Accordingly, credit risk management should be understood as an integral element of stability-oriented banking investment strategies (Wahinya et al., 2023).

Moreover, the findings indicate that the relationship between credit risk and bank stability is mediated by banks' risk-taking behavior. Incentives to assume higher risk under certain conditions may amplify credit exposure and systemic vulnerability. This interpretation aligns with literature identifying risk-taking behavior as a key transmission channel of credit risk to financial system stability (Wahinya et al., 2023).

The results also highlight that credit risk interacts with market risk and global liquidity pressures. In periods of heightened volatility and economic uncertainty, unmanaged credit risk may accelerate systemic stress transmission. Therefore, integrating credit risk management within broader risk management frameworks constitutes a critical implication of this study (Nwachukwu et al., 2021).

Overall, the Discussion underscores that credit risk management has strategic implications beyond internal control functions. By positioning credit risk management as an investment risk strategy, banks can balance return generation and

risk control while strengthening long-term financial stability. These findings contribute conceptually to the banking stability literature by emphasizing the importance of integrated, system-oriented credit risk management approaches (Adem, 2022).

## **6. Conclusion**

This study demonstrates that credit risk management plays a strategic role as an investment risk strategy with direct implications for bank stability. Through a synthesis of recent literature, the findings indicate that credit risk—particularly as reflected in rising non-performing loans—serves as a primary mechanism influencing asset quality, liquidity, and banks' capacity to extend credit and support investment expansion. Consequently, credit risk should not be viewed solely as an operational issue but as a structural factor shaping banking financial resilience.

The review further highlights that credit risk management practices—including credit quality monitoring, portfolio diversification, risk-taking control, and integration with broader risk management frameworks—are essential for mitigating investment risk and strengthening bank stability. These practices enable banks to manage risk exposure adaptively amid market volatility and global liquidity pressures, thereby supporting sustainable intermediation functions.

Conceptually, this study contributes by positioning credit risk management as an integral component of stability-oriented banking investment strategies. The findings enrich the banking stability literature by emphasizing the importance of integrated and system-wide credit risk management perspectives.

Future research may extend this framework through cross-country empirical analysis or crisis-period investigations to further examine the effectiveness of specific credit risk management practices in enhancing bank stability. Nonetheless, as a qualitative and conceptual SLR, this study provides a solid theoretical foundation for strategic decision-making in the banking sector.

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