



RM — Risk Management

Complete Book | Table of Contents | 40 chapters + 6 sections

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LEARNING
SESSIONS

CH-1 Why Banks are Special

Topic 1 — Why Banks are Special

Banks play a **critical role in the economy**: they **operate the payment system**, are the **major source of credit** for a large section of the economy, and are trusted by people to keep their **surplus funds**.

- Banks provide **non-fund facilities** such as **bank guarantees** and **letters of credit**, which create **contingent obligations**.
- The **global financial turmoil** changed the banking structure, bank strategies and performance, and the way banks are **regulated and supervised**.

Topic 2 — Functions Banks Perform

Financial institutions **channelise funds** from people who have **surplus funds** to people who **need funds**.

Unit	Position	Role in fund flow
Savings surplus units	Households, businesses and governments that spend less than their income	Sources of funds (lender-savers)
Savings deficit units	Households, businesses, governments and foreign entities whose current need exceeds current income	Users of funds (borrower-spenders)

- Value added** — A borrower who invests in a business or in machines and equipment **adds value**.
- More output** — The investment produces more goods and services.
- Growth** — The economy grows, and a growing economy **creates jobs** and adds to income.

Topic 3 — Economy Without Efficient Financial Institutions

Without efficient financial institutions, the **fund flow** between surplus and deficit units is likely to be **very low**, for three reasons.

Reason	Why it blocks direct lending
High monitoring cost	Households must check that the business keeps earning enough to repay. They must watch for a fall in the borrower's creditworthiness . This takes considerable time and cost. It discourages direct investment in corporate instruments.
Liquidity and maturity mismatch	Long-term debt may mature later than savers want; shares have no fixed maturity . Selling early may involve illiquidity, transaction costs or price loss .
Price risk	Even if a financial market exists where instruments can be traded, savers remain exposed to price risk .

Topic 4 — Bank's Role in the Economy

Role	Key points
Financial intermediation	Banks channel savings from depositors to borrowers. Deposits are bank liabilities . Savings and eligible term deposits earn interest; current accounts generally do not . The spread (interest earned minus paid) is the main profit.
Depositors at risk and safety net	Depositors do not evaluate the bank's credit quality. They assume full repayment on demand, which puts them at risk. The safety net differs by country. It is generally not unlimited , so some deposits stay exposed to bank default.
Asset transformation	Transforming bank liabilities (deposits) into bank assets (loans) with divergent characteristics — translating the product specifications wanted by savers into those wanted by borrowers.
Diversification benefits	Banks give savers highly liquid, low-risk products and invest in illiquid, high-risk assets. Diversifying away firm-specific risk makes this possible. Depositors claim on the bank, not on loans. Common shocks and bank-failure risk remain .
Maturity transformation	Savers have short horizons and want liquid reserves for shocks (unemployment, medical emergencies). Businesses need long-term project finance or short-term working capital. Banks bear this maturity mismatch.
Better liquidity products	SB and current accounts allow demand withdrawals , subject to funds, terms and law. SB balances earn interest. Early term-deposit withdrawal depends on the product. Non-callable deposits may not allow it; callable ones may carry a penalty.

- Insurer** — DICGC is a wholly owned subsidiary of RBI.
 - Limit** — It insures eligible deposits up to **₹5 lakh per depositor per bank**.
 - What is covered** — The limit covers **principal and interest together**, in the **same right and capacity**.
 - Aggregation** — Deposits in all branches of the bank in the same capacity are **aggregated**.
 - Basis** — Cover is **per bank, not per account**.
- Example:** One million deposits of ₹1,000 each total ₹100 crore (₹1 billion), equal to 10,000 loans of ₹1 lakh each before reserves and liquidity needs. Each depositor has a claim on the bank, not a direct share in those loans.
- Hedging and securitisation** can transfer selected risks within regulatory rules. **Credit default swaps** introduce **counterparty and basis risk**; neither tool eliminates all funding or credit risk.
- Remember this**
- DICGC cover: **₹5 lakh per depositor per bank**, principal + interest, same right and capacity.

Topic 5 — Uniqueness of Banks

Besides the benefits of intermediation, banks carry out certain **unique services** which make them special.

Special function	Key points
Transmission of monetary policy	The monetary transmission mechanism links monetary policy to aggregate demand , asset prices, interest rates, money and credit. Policy-rate changes shift borrowing and lending conditions. Transmission is neither immediate nor uniform .
Credit allocation	Banks are often the major — sometimes only — source of finance for the priority sector . Bank loans need frequent renewal . So banks keep re-checking firms' creditworthiness . Growth follows credit flow; monetary policy gives direction.

Special function	Key points
Creation of money	A bank loan creates a matching deposit ; loan repayment reduces deposit money . Paying another bank needs settlement. Lending depends on capital, liquidity, profitability, credit demand and monetary policy . The money multiplier is not fixed.
Payment services	Clearing and transfer of funds keep money moving. A breakdown would cause gridlock in the payment system and harm the economy.
Financial inclusion	Ensures ease of access, availability and usage of the formal financial system for all. It broadens the resource base by building a savings culture in rural areas and reduces exploitation by usurious moneylenders .
Digital and inclusive banking	Services reach remote areas without physical branches . Digital technology saves time and reduces operating cost . It improves monitoring, risk management and control. Customers transact quickly and securely without visiting branches.

RM | Module A | CH-1 | MCQs

Q1. A bank lends ₹50 lakh to a manufacturer by crediting the borrower's current account. What is the immediate effect on broad money? [Ref: Topic 5, p. 3]

- (a) Money falls by ₹50 lakh
(b) A matching deposit of ₹50 lakh is created
(c) No effect until RBI injects reserves
(d) Money rises by ₹50 lakh × money multiplier

Q2. Mr. X holds an SB account of ₹3 lakh and an FD of ₹4 lakh (both in his single name) in two branches of the same bank, which fails. What is the maximum DICGC claim? [Ref: Topic 4, p. 3]

- (a) ₹7 lakh (b) ₹4 lakh (c) ₹5 lakh (d) ₹10 lakh

Q3. Mrs. Y has ₹4 lakh each in Bank A and Bank B in her individual capacity. Both banks fail. Total DICGC protection available to her is: [Ref: Topic 4, p. 3]

- (a) ₹5 lakh (b) ₹4 lakh (c) ₹10 lakh (d) ₹8 lakh

Q4. Households hesitate to lend directly to a company mainly because tracking the company's ability to repay requires considerable time and cost. This barrier is called: [Ref: Topic 3, p. 3]

- (a) High monitoring cost (b) Price risk
(c) Settlement risk (d) Transmission lag

Q5. A bank collects ₹1,000 savings deposits from many households and grants a ₹5 crore 10-year project loan. Changing the size and characteristics of funds in this way is: [Ref: Topic 4, p. 3]

- (a) Credit allocation (b) Payment service
(c) Asset transformation (d) Monetary transmission

Q6. Banks can offer liquid, low-risk deposits while holding illiquid, risky loans chiefly because they can: [Ref: Topic 4, p. 3]

- (a) Guarantee every loan with collateral
(b) Diversify away firm-specific risk across many borrowers
(c) Borrow unlimited funds from RBI
(d) Avoid all common economic shocks

Q7. Funding 20-year home loans with 1-year term deposits is an example of: [Ref: Topic 4, p. 3]

- (a) Maturity transformation (b) Diversification
(c) Financial inclusion (d) Securitisation

Q8. A bank buys protection through a credit default swap on a large corporate exposure. Which risk does it now take on? [Ref: Topic 4, p. 3]

- (a) No risk at all remains (b) Only interest rate risk
(c) Only liquidity risk (d) Counterparty and basis risk

Q9. RBI cuts the policy repo rate, but lending rates of banks fall only gradually and unevenly. This reflects that monetary transmission is: [Ref: Topic 5, p. 3]

- (a) Immediate and uniform (b) Neither immediate nor uniform
(c) Independent of banks (d) Determined only by CRR

Q10. Which statement on bank money creation is correct? [Ref: Topic 5, p. 3]

- (a) Lending is fixed by reserves × multiplier
(b) Loan repayment increases deposit money
(c) Lending also depends on capital, profitability and credit demand
(d) Banks cannot create money; only RBI can

Q11. A customer wants to close a non-callable term deposit before maturity. The correct position is: [Ref: Topic 4, p. 3]

- (a) Bank must always allow it without penalty
(b) It may not be permitted under the product terms
(c) DICGC will pay the amount
(d) Interest is doubled

Q12. Which of the following is a non-fund facility creating a contingent obligation for the bank? [Ref: Topic 1, p. 3]

- (a) Cash credit (b) Term loan
(c) Overdraft (d) Bank guarantee

Q13. A saver buys a long-term corporate bond and has to sell it suddenly after rates rise. The loss on sale reflects: [Ref: Topic 3, p. 3]

- (a) Credit risk (b) Settlement risk
(c) Model risk (d) Price (market) risk

Q14. Delivering banking services in remote villages through mobile apps and business correspondents without a branch is an example of: [Ref: Topic 5, p. 3]

- (a) Asset transformation (b) Digital and inclusive banking
(c) Credit rationing (d) Maturity mismatch

Q15. Which statement on depositors is correct? [Ref: Topic 4, p. 3]

- (a) Depositors normally evaluate the bank's credit quality before depositing
(b) DICGC cover is unlimited for all deposits
(c) Depositors usually assume their deposit is safe and repayable on demand
(d) Depositors own a share of each loan

Answer key

Q	Ans	Q	Ans	Q	Ans	Q	Ans	Q	Ans
1	b	4	a	7	a	10	c	13	d
2	c	5	c	8	d	11	b	14	b
3	d	6	b	9	b	12	d	15	c

CH-2

Risks and Risk Management in Banks

Topic 1 — Risk in Banking

- Risk machines** — Banks are commercial entities that generate risks like 'risk machines'.
- Inherent** — Risk is inherent in a bank's nature and structure because of the functions it performs.
- New risks** — External connectivity and product diversity have created many **known and unknown risks**.
- Significance** — Risk management has therefore assumed great significance.
- Meaning** — Risk is anything that can have an **adverse impact on the fulfilment of corporate objectives**.