

ORM — Operational Risk Management

Complete Book | Table of Contents | 24 chapters + 9 sections

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CH-1

The Evolution of Risk Management in Indian Banking: From Tradition to Transformation

Topic 1 — Risk Management Practices in Ancient India

Risk management in India is older than modern banking: ancient texts already **priced**, **documented** and **controlled** lending risk.

- **Indigenous lenders** — Merchant-bankers (*sreshthis*), moneylenders and craft guilds (*shrenis*) accepted deposits and gave loans.
- **Loan deeds** — Deeds called *mapatra* or *rnalekhya* recorded the debtor, creditor, amount, interest rate and repayment terms.
- **Security** — Smriti texts recognised pledges (*adhi*) and sureties (*pratibhu*) as protection against default.
- **Payment orders** — In the Mauryan period, an *adesha* ordered a banker to pay a third person, much like a bill of exchange.

Kautilya's Arthashastra: risk-based pricing of loans

Borrower or venture	Interest per 100 panas a month	Simple annual rate	Risk logic
Ordinary loan ("just" rate)	1¼ panas	15%	Normal risk
Commercial loan (<i>vyavaharika</i>)	5 panas	60%	Business risk of trade
Traders through forests	10 panas	120%	Robbery and transit risk
Sea traders	20 panas	240%	Shipwreck and piracy — highest risk

- **Rate ceiling** — Lenders who charged above these rates were fined — an early conduct rule.
- **Limitation** — Debts neglected for **ten years** were generally not recoverable, except for minors, the sick or persons abroad.
- **Embezzlement** — Kautilya listed about **40 ways of embezzlement** by officials — an early catalogue of internal fraud.
- **Job rotation** — Officials were transferred from one work to another so that they could not misappropriate funds.
- **Accounts** — Accounts were due in a fixed month (*Ashadha*); late or wrongly written accounts attracted fines.

Example: Kautilya wrote that just as one cannot avoid tasting honey on the tip of the tongue, an official handling revenue will be tempted to take a little. Banks answer the same temptation today with **maker-checker**, **mandatory leave** and **rotation of staff** in sensitive posts.

Remember this

- Arthashastra rates **per month**: 1¼% (just), 5% (commercial), 10% (forest), 20% (sea) — India's earliest recorded **risk-based pricing**.

Topic 2 — Risk Management Practices during the Mughal Period

- **Sarrafs** — Sarrafs (shroffs) changed money, tested coins, accepted deposits, gave loans and issued hundis.
- **Coinage** — The silver rupiya of Sher Shah Suri, continued by the Mughals with the gold mohur and copper dam, gave a standard unit of account.

- **Batta** — Sarrafs charged a discount (*batta*) on worn or older coins, pricing the risk of short weight.
- **Loan deeds** — Deeds (*dastawez*) were payable on demand (*indultalab*) or after a fixed time (*miadi*).

Hundi	Feature	Risk managed
Darshani	Payable on sight, like a demand bill	Remittance risk — cash need not travel
Muddati (miadi)	Payable after a fixed period, like a usance bill	Liquidity — credit for the trade cycle
Nam-jog	Payable only to the person named	Theft and wrong-payment risk
Jokhmi	Drawn against goods shipped; payment linked to their safe arrival	Transit risk shared — trade credit combined with insurance

- **Insurance premium** — Bills of exchange on foreign places, used for sea-borne trade, were discounted heavily; the discount included an **insurance premium**.
- **Revenue remittance** — Banking houses remitted provincial revenue through hundis, avoiding the risk of carrying coin.

Jagat Seth and the Dahsala system

- **Jagat Seth** — The Murshidabad banking house held the Mughal title *Jagat Seth*, "banker of the world".
- **Functions** — It ran the Bengal mint, used its credit network to remit the Nawabs' tribute to Delhi and lent to the East India Company.
- **Concentration** — It declined after the British moved the treasury and mint to Calcutta — a lesson in **dependence on one patron**.
- **Dahsala (1580)** — Raja Todar Mal, Akbar's revenue minister, fixed cash rates on the **average yields and prices of ten years**.
- **Risk logic** — Averaging smoothed year-to-year swings; schedules could be revised after famine or a major change in crops.

Remember this

- Dahsala averaged **10 years**; Basel's Basic Indicator Approach averages **3 years** of gross income — the same smoothing idea.

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Topic 3 — Risk Management in Pre-Independent India

Period	Development	Risk lesson
1770	Bank of Hindustan, Calcutta — the first joint-stock bank; introduced cheques	Banking began with no regulator
1806–1843	Presidency Banks: Bank of Bengal (founded 1806 as the Bank of Calcutta), Bank of Bombay (1840), Bank of Madras (1843)	Government-linked; note issue within set limits
1833	Bank of Bengal offers cash credit against security, up to 1 lakh sicca rupees	Secured lending within a limit
1861	Paper Currency Act — Government monopoly of note issue	Note-issue risk removed from banks
1881	Negotiable Instruments Act	Legal certainty for bills and cheques
1906–1911	Swadeshi banks: Bank of India, Canara Bank, Indian Bank, Bank of Baroda, Central Bank of India	Rapid growth on thin capital
1913–14	Wave of bank failures	No regulator, no deposit insurance
1921	Presidency Banks merged into the Imperial Bank of India	Scale; settlement through one bank
1 April 1935	RBI begins operations under the RBI Act, 1934	Lender of last resort; cash reserves
1938	Travancore National and Quilon Bank fails	Regional systemic shock
1946–48	Banking crisis in Bengal	Revived the case for deposit insurance

- **Cash reserves** — Section 42 of the RBI Act made scheduled banks keep cash reserves with RBI (originally 5% of demand and 2% of time liabilities).
- **Push for reform** — The Hilton Young Commission (1926) and the Central Banking Enquiry Committee (1931) pressed for a central bank and banking law.

Example: A Swadeshi-era bank, **Lahore Swadeshi Bank** (fictional), lends 60% of its deposits to firms owned by its own promoters. When one firm fails, rumours spread and depositors queue up. With no central bank and no deposit insurance, the bank closes — showing **connected lending, concentration and liquidity** risk together.

Remember this

- First joint-stock bank 1770; Imperial Bank 1921; RBI from 1 April 1935; no deposit insurance until 1962.

Topic 4 — Post-Independence Era: From Private to Public Banking (1947–1960s)

- **RBI nationalised** — The Central Government took over RBI with effect from 1 January 1949.
- **Banking law** — The Banking Companies Act, 1949 (renamed the Banking Regulation Act in 1966) took effect on 16 March 1949.
- **Licensing and inspection** — Section 22 required an RBI licence; Section 35 empowered RBI to inspect any bank.
- **Liquidity** — Section 24 introduced the statutory liquidity ratio, initially 20% of demand and time liabilities.
- **SBI** — The Imperial Bank became **State Bank of India** on 1 July 1955, on the Rural Credit Survey's advice.
- **Subsidiaries** — The SBI (Subsidiary Banks) Act, 1959 brought state-associated banks under SBI.

Risk faced	Regulatory response
Many small, weak banks	RBI-led amalgamations: insured banks fell from 287 in the early 1960s to 100 by end-1967
Depositor loss after the failures of Laxmi Bank and Palai Central Bank (1960)	Deposit Insurance Corporation began on 1 January 1962
Credit concentrated in large industrial borrowers	Credit Authorisation Scheme (1965): prior RBI approval for large credit limits

Remember this

- DIC from 1 January 1962 → DICGC from 15 July 1978; cover today ₹5 lakh per depositor per bank.

Topic 5 — Social Control and Nationalisation Era (1960s–1980s)

- **Social control** — Announced in December 1967 to align bank credit with plan priorities; the National Credit Council was set up the same month.
- **1968 amendment** — The Banking Laws (Amendment) Act, 1968 required boards with specialised knowledge and a whole-time professional chairman.
- **Insider lending** — Loans to directors and their concerns were prohibited (Section 20) — a control on **related-party risk**.

Measure	Date	Coverage
First nationalisation	19 July 1969	14 banks with deposits over ₹50 crore
Lead Bank Scheme	December 1969	Area-based credit planning
Credit Guarantee Corporation of India	14 January 1971	Guarantees for small borrowers
Regional Rural Banks	1975	Credit to the rural poor
DICGC	15 July 1978	DIC and CGCI merged
Second nationalisation	15 April 1980	6 banks with deposits over ₹200 crore
NABARD	12 July 1982	Apex rural refinance

Risks that built up

- **Directed credit** — Priority-sector targets rose to 40% of credit by 1985, often with weak appraisal.
- **Administered rates** — RBI fixed deposit and lending rates, so pricing did not reflect borrower risk.
- **Branch expansion** — Rural branch growth outpaced training, supervision and internal controls.
- **Need-based lending** — The Tandon (1975) and Chore (1980) Committees tightened working-capital discipline.
- **Weak accounting** — Interest was booked on accrual even on doubtful loans; capital stayed thin.

Example: **Vindhya Gramin Bank** (fictional) opens 40 rural branches in two years, staffed mostly by new recruits. Ledgers are hand-posted, inspection reaches a branch once in three years and many loan files lack documents. Later losses are partly **operational** — missing documents and weak supervision — not only borrower default.

Remember this

- 1969: **14 banks** (deposits over ₹50 crore); 1980: **6 banks** (deposits over ₹200 crore).

Topic 6 — Early Modernization and Emerging Challenges (1980s)

- **Mechanisation** — The Rangarajan Committee (1984) started mechanisation of bank branches with ledger-posting machines.

- **Clearing** — A National Clearing Cell (November 1983) and MICR cheque processing (March 1987) mechanised clearing.
- **Health Code System (1985)** — RBI graded advances into **eight health codes**, from satisfactory to bad and doubtful — an early asset-quality tracker.
- **Money market** — 182-day Treasury Bills (1986), DFHI (1988), Certificates of Deposit (1989) and Commercial Paper (1990) widened instruments.
- **Rate freedom** — The maximum lending rate was abolished in October 1988; banks could price by the borrower's record.

Change	New operational risk
Ledger-posting machines and computers	Data-entry errors, system downtime, key-person dependence
MICR clearing	Processing errors; fraudulent instruments passing in bulk
New money-market instruments	Dealing-room and settlement errors
Partial computerisation	Parallel manual and machine records that do not reconcile

Remember this

- 1980s: Health Code (**8 codes**, 1985), MICR (1987), DFHI (1988), CDs (1989), CP (1990).

Topic 7 — Pre-Reform Period: Mounting Systemic Risks (1980s–1991)

- **Pre-emption** — CRR rose to **15%** on 1 July 1989; with SLR peaking at **38.5%**, over half of deposits were locked away.
- **Asset quality** — No objective NPA norm existed; interest on bad loans was still booked as income.
- **Capital** — There was no risk-based capital requirement; many banks' net worth was eroded.
- **Credit culture** — Loan melas and the Agricultural and Rural Debt Relief Scheme, 1990 (relief up to **₹10,000**) weakened repayment discipline.
- **External shock** — In 1991 reserves covered only a few weeks of imports; the rupee was devalued about **18%** on 1 and 3 July 1991.

Risk type	How it showed before 1991
Credit	Hidden NPAs; directed and politically influenced lending
Market and interest rate	Administered rates; long-dated government securities at below-market coupons
Liquidity and structure	Over 53% pre-emption limited lendable funds
Operational	Manual systems, weak MIS, arrears in balancing books and reconciling inter-branch accounts
Solvency	No capital adequacy norm; losses hidden by accrual accounting

Remember this

- Pre-reform pre-emption: CRR **15%** + SLR **38.5%** = **53.5%** of liabilities.

Topic 8 — The 1991 Economic Reforms: A Watershed Moment for Indian Banking and Risk Management

The **Committee on the Financial System** (Narasimham Committee I) was appointed in August 1991 and reported in November 1991.

Recommendation	What followed
Cut SLR to 25% over five years and reduce CRR	SLR and CRR lowered in phases; today CRR 3% and SLR 18%

Recommendation	What followed
Prudential income recognition, asset classification and provisioning (IRAC)	Introduced April 1992; NPA at 180 days overdue, tightened to 90 days from 31 March 2004
Capital adequacy of 8% of risk-weighted assets (Basel I)	From April 1992, with phased compliance by 1994 and 1996
Deregulate interest rates	Lending rates freed in October 1994 (Prime Lending Rate)
Entry of new private and foreign banks	Guidelines for new private banks in 1993
Faster recovery of bank dues	Debt Recovery Tribunals under the 1993 Act
Independent supervision	Board for Financial Supervision, November 1994
Reduce directed credit to 10%	Not accepted ; priority-sector target stays at 40%

Why 1991 was a watershed for risk management

- **Recognition** — Losses had to be recognised objectively under NPA norms.
- **Capital link** — Capital became a function of risk-weighted assets.
- **Market pricing** — Freed interest rates made market risk and asset-liability management real concerns.
- **Competition** — New private banks brought technology, competition and pressure on costs.

N1. [Numerical] A bank has liabilities of ₹10,000 crore.

Compare its lendable resources under pre-reform pre-emption (CRR 15%, SLR 38.5%) and today's levels (CRR 3%, SLR 18%).

Item	Value
Liabilities (NDTL)	₹10,000 crore
Pre-reform CRR + SLR	15% + 38.5%
Current CRR + SLR	3% + 18%

Solution:

Formula:

$$\text{Lendable} = \text{NDTL} \times (1 - \text{CRR} - \text{SLR})$$

Pre-reform pre-emption = $10,000 \times 53.5\% = ₹5,350$ crore; lendable = ₹4,650 crore.

Current pre-emption = $10,000 \times 21\% = ₹2,100$ crore; lendable = ₹7,900 crore.

Increase = $7,900 - 4,650 = ₹3,250$ crore, about 69.9% more lendable funds.

Answer: Lendable resources rise from ₹4,650 crore to ₹7,900 crore (+₹3,250 crore).

Remember this

- Narasimham I (1991): SLR → 25%, CRAR 8%, IRAC norms (April 1992), DRTs (1993), BFS (November 1994).

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Topic 9 — Post-Reform and Contemporary Banking

When	Milestone	Significance for risk management
1998	Narasimham Committee II	Higher capital, tighter NPA norms
February 1999	Asset-Liability Management guidelines	Liquidity and interest-rate gap control
7 October 1999	Risk Management Systems in Banks guidelines	Covered credit, liquidity, interest-rate, forex and operational risks
2002	SARFAESI Act; Prompt Corrective Action framework	Faster recovery; early supervisory action
14 October 2005	Guidance Note on Management of Operational Risk	First RBI operational risk framework
From 2012-13	Risk-based supervision	Supervision by risk profile
2015	Asset Quality Review	Hidden stress recognised
2016	Insolvency and Bankruptcy Code	Time-bound resolution
1 April 2020	Ten public sector banks merged into four; 12 remain	Scale and consolidation
30 April 2024	Guidance Note on Operational Risk Management and Operational Resilience	Replaced the 2005 note; adds resilience; re-issued on 28 November 2025
28 November 2025	Entity-wise consolidated Directions	One rulebook for each type of regulated entity

Contemporary risk landscape

- **Digital scale** — UPI and mobile banking moved risk to real-time, high-volume channels.
- **Cyber and vendors** — Cyber attacks and failures of technology service providers are now top operational risks.
- **Fraud value** — RBI's Annual Report 2025-26 shows frauds of ₹1 lakh and above at **₹48,021 crore** in **10,114 cases** in 2025-26.
- **Forward-looking provisions** — The Expected Credit Loss framework applies from **1 April 2027**.
- **Credit risk capital** — Revised standardised approach Directions (27 April 2026) apply from **1 April 2027**.
- **From 31 July 2026 — after the exam cut-off** — RBI issued the Commercial Banks – Cybersecurity, Technology; Risk, Resilience and Assurance Framework Directions, 2026 and the Digital Payment Security Controls Directions, 2026.

Remember this

- RBI operational risk guidance: **14 October 2005** → replaced by the Guidance Note of **30 April 2024** (3 pillars, 17 principles), re-issued on **28 November 2025**.

Topic 10 — Implementation of Basel Committee Recommendations

- **BCBS** — Set up by the G10 central bank governors at the end of 1974, after the Herstatt failure.
- **Legal status** — Basel standards have no legal force until a national authority adopts them.
- **India** — RBI adopts them through its own directions and is often stricter, e.g., minimum total capital of **9%** against Basel's 8%.

Basel standard	Issued by BCBS	Implementation in India
Basel I (credit risk)	1988	Capital adequacy from April 1992 at 8%; minimum later raised to 9%
Market Risk Amendment	1996	Capital charge for market risk on the trading book, phased in during the mid-2000s
Basel II (three pillars; operational risk capital)	June 2004	By 31 March 2008 (foreign banks and Indian banks with overseas presence) and 31 March 2009 (others); BIA for operational risk
Basel III	December 2010	From 1 April 2013 ; full capital conservation buffer from 1 October 2021; LCR from 1 January 2015; NSFR from 1 October 2021
Basel III final reforms	December 2017	Credit risk standardised approach from 1 April 2027 ; operational risk Standardised Approach awaiting a start date as at 30 June 2026

Operational risk capital in India

- **Current method** — As at 30 June 2026, banks use the **Basic Indicator Approach**: 15% of average positive annual gross income of the previous three years.
- **RWA** — Operational risk RWA = capital charge × 12.5.
- **New Standardised Approach** — Capital = Business Indicator Component × Internal Loss Multiplier; it sits in Chapter IV of the Commercial Banks – Forthcoming Instructions Directions, 2025, with its start date yet to be notified at the cut-off.

$$K_{BIA} = \frac{\sum_{i=1}^n GI_i \times 15\%}{n}$$

$$RWA_{op} = K_{BIA} \times 12.5$$

N2. [Numerical] Gross income of Sutej Bank (fictional) for the last three years was ₹2,400 crore, ₹2,800 crore and –₹200 crore. Find its operational risk capital charge and RWA under BIA.

Item	Value
Year 1 gross income	₹2,400 crore
Year 2 gross income	₹2,800 crore
Year 3 gross income	–₹200 crore
Alpha	15%

Solution:

Formula:

$$K_{BIA} = \frac{\sum GI_{positive} \times 15\%}{n_{positive}}$$

Exclude the negative year from both numerator and denominator: n = 2.

Average positive gross income = (2,400 + 2,800) ÷ 2 = ₹2,600 crore.

Capital charge = 2,600 × 15% = ₹390 crore.

RWA = 390 × 12.5 = ₹4,875 crore.

Answer: Capital charge ₹390 crore; operational risk RWA ₹4,875 crore.

- **From 23 October 2026 — after the exam cut-off** — RBI notified that the operational risk Standardised Approach chapter takes effect from **1 April 2027**.
- **Also after the cut-off** — The Market Risk Directions (21 September 2026, Simplified Standardised Approach) and the Credit Valuation Adjustment Framework Directions (7 October 2026) also apply from **1 April 2027**.

Remember this

- India: CRAR **9%** (Basel 8%), **11.5%** with CCB; operational risk capital under BIA (**15%**, 3-year average) as at the cut-off.

**ORM | Module A | CH-1 | MCQs**

Q1. Kautilya fixed 20 panas per 100 a month for sea traders but only 1¼ panas for an ordinary loan. In modern terms, this is best described as: [Ref: Topic 1, p. 2]

- (a) A uniform usury ceiling applicable equally to every class of borrower
- (b) Risk-based pricing that loads interest for a higher chance of loss
- (c) A liquidity premium charged for the longer tenor of voyages
- (d) Penal interest levied for delay in repayment of the loan

Q2. A bank moves cash-handling officers to a different desk every two years so that no one controls the same funds for long. Which Arthashastra practice does this mirror? [Ref: Topic 1, p. 2]

- (a) Fixing a just rate of 1¼ panas a month
- (b) Barring debts neglected for ten years
- (c) Recording loans in deeds with amount and interest
- (d) Transferring officials from one work to another

Q3. A Mughal-era merchant shipping indigo by sea draws a jokhmi hundi on the buyer. Its risk-management feature is that: [Ref: Topic 2, p. 2]

- (a) Payment depends on the safe arrival of the goods, sharing transit risk
- (b) Payment is made on sight, so no credit risk remains with the payee
- (c) Payment is made only to the named person, so theft is prevented
- (d) Payment falls due after a fixed usance period, financing the trade

Q4. The Dahsala system fixed revenue rates on the average yields and prices of ten years. This idea is closest to which modern practice? [Ref: Topic 2, p. 2]

- (a) Treating a loan as a non-performing asset once it is 90 days overdue
- (b) Assigning risk weights to assets under Basel I
- (c) Averaging three years of gross income for operational risk capital
- (d) Keeping a cash reserve ratio with the central bank

Q5. Which of the following statements about sarrafs in the Mughal period is NOT correct? [Ref: Topic 2, p. 2]

- (a) They tested coins for purity and charged batta on worn or old coins
- (b) They issued and discounted hundis for traders
- (c) They accepted deposits and made loans to merchants
- (d) They were the statutory note-issuing authority of the Mughal state

Q6. Which pre-independence measure removed the risk of note issue from private and Presidency banks? [Ref: Topic 3, p. 3]

- (a) The Negotiable Instruments Act, giving legal basis to bills and cheques
- (b) The Paper Currency Act, giving the Government a monopoly of note issue
- (c) The merger of the Presidency Banks into the Imperial Bank of India
- (d) Section 42 of the RBI Act on cash reserves of scheduled banks

Q7. A Swadeshi-era bank fails after rumours about its promoter's firms, and depositors lose their savings. Which two safeguards, missing then, would limit such losses today? [Ref: Topic 3, p. 3]

- (a) Deposit insurance and a central bank as lender of last resort
- (b) A Government monopoly of note issue and the Negotiable Instruments Act
- (c) Presidency bank charters and limits on note issue
- (d) Cash credit limits and inland bills such as Post Bills

Q8. Which pair of measures in the 1960s directly addressed the risk of depositor loss from bank failures? [Ref: Topic 4, p. 3]

- (a) The Lead Bank Scheme and Regional Rural Banks
- (b) The Credit Authorisation Scheme and Tandon norms
- (c) Deposit insurance and RBI-led amalgamation of weak banks
- (d) Social control and the National Credit Council

Q9. The ban on bank loans to directors and their concerns, introduced under social control, was mainly aimed at: [Ref: Topic 5, p. 3]

- (a) Maturity mismatch in the bank's balance sheet
- (b) Foreign-exchange risk on open positions
- (c) Settlement risk in interbank clearing
- (d) Related-party (connected) lending risk

Q10. Which of these were risks that built up during the nationalisation era? 1. Administered interest rates unrelated to borrower risk 2. Branch expansion outpacing controls 3. Objective 90-day NPA recognition 4. Booking interest on doubtful loans as income [Ref: Topic 5, p. 3]

- (a) 1, 2 and 4 only
- (b) 1, 2 and 3 only
- (c) 2, 3 and 4 only
- (d) 1, 2, 3 and 4

Q11. A bank in the late 1980s installs ledger-posting machines and joins MICR clearing. Which risk most needs new controls? [Ref: Topic 6, p. 3]

- (a) Sovereign default risk on government securities
- (b) Data-entry, processing and system-failure risk
- (c) Currency-conversion risk on export bills
- (d) Rating-migration risk on corporate loans

Q12. Before the reforms, CRR was 15% and SLR 38.5%. Ignoring other uses of funds, how much of ₹1,000 crore of liabilities could a bank lend? [Ref: Topic 7, p. 4]

- (a) ₹615 crore
- (b) ₹850 crore
- (c) ₹465 crore
- (d) ₹535 crore

Q13. Which recommendation of the Narasimham Committee I was NOT accepted? [Ref: Topic 8, p. 4]

- (a) Introducing prudential income recognition and asset classification norms
- (b) Requiring capital adequacy of 8% of risk-weighted assets
- (c) Permitting the entry of new private sector banks
- (d) Reducing directed credit to the priority sector to 10%

Q14. RBI data show frauds of ₹32,803 crore in 23,722 cases in 2024-25 and ₹48,021 crore in 10,114 cases in 2025-26. Which inference is valid? [Ref: Topic 9, p. 5]

- (a) Net losses after recoveries rose by the same 46% as the amount involved
- (b) The average amount per fraud rose sharply, pointing to fewer but larger frauds
- (c) Every fraud reported in 2025-26 also took place during 2025-26
- (d) Digital-payment frauds formed the largest share of the amount involved

Q15. Gross income of a bank for three years was ₹600 crore, ₹800 crore and –₹100 crore. Its operational risk capital charge under BIA is: [Ref: Topic 10, p. 5]

- (a) ₹105 crore
- (b) ₹65 crore
- (c) ₹70 crore
- (d) ₹210 crore

Answer key

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

CH-2

Understanding the Nature of Risk

Topic 1 — Risk as Part of Life

- **Everyday choices** — Crossing a road, investing savings or starting a business all carry an uncertain outcome.
- **Unavoidable** — Risk cannot be eliminated; it can only be understood, reduced, transferred or accepted.
- **Reward link** — Progress and return come only from taking some risk.
- **Banking** — A bank exists to take risk: it accepts deposits repayable on demand and lends for years.
- **Aim** — Good risk management does not avoid risk; it takes risks that are **known, measured and rewarded**.

Everyday action	Risk faced	Banking parallel
Lending money to a friend	Non-repayment	Credit risk
Buying gold or shares	Fall in price	Market risk
Keeping no cash for emergencies	Unable to pay when needed	Liquidity risk
Driving a vehicle	Accident from error or breakdown	Operational risk in branches and systems
Buying health insurance	Cost of illness shifted to insurer	Insurance as risk transfer

Four responses to risk

Response	Meaning	Bank example
Avoid (terminate)	Do not undertake the activity	Decline a product outside risk appetite
Reduce (treat)	Lower likelihood or impact through controls	Maker-checker on high-value payments
Transfer	Shift the financial impact to another party	Bankers' indemnity or cyber insurance
Accept (tolerate)	Retain the risk knowingly	Absorb small cash shortages within limits

Remember this

- Four responses: **Avoid, Reduce, Transfer, Accept** — chosen by comparing the risk with the bank's **risk appetite**.

Topic 2 — Definition of Risk

There is no single definition of risk; each definition stresses a different aspect.

Source	Definition	Emphasis
Common usage	The possibility of loss, injury or damage	Downside only
Finance	Variability of actual returns around expected returns	Volatility — upside and downside
ISO 31000:2018	"Effect of uncertainty on objectives"; the effect is a deviation from the expected	Positive or negative deviation
COSO ERM (2017)	The possibility that events will occur and affect the achievement of strategy and business objectives	Link to strategy and performance
Banking usage	The potential that events, expected or unexpected, harm the bank's capital or earnings	Capital and earnings

- **Common thread** — Every definition contains an **objective**, an **uncertain future event** and a **consequence**.
- **No objective, no risk** — Without a target or expected result there is only uncertainty, not risk.
- **Two-sided** — Modern standards treat risk as two-sided; an upside deviation is an opportunity.
- **Downside in practice** — Banks manage mostly downside risk; operational risk is almost entirely downside.

Pure risk and speculative risk

Basis	Pure risk	Speculative risk
Possible outcomes	Loss or no loss	Loss, no change or gain
Bank example	Fire at a branch; employee fraud	Bond portfolio; open forex position
Insurability	Generally insurable	Generally not insurable
Banking link	Most operational risk	Market risk and much of credit risk

Example: Narmada Bank (fictional) targets a return on assets of 1.2%. Actual return could be 1.5% (upside) or 0.6% (downside). Under ISO 31000 both are risk; the bank's capital planning focuses on the downside.

Topic 3 — Definition of Risk: Risk versus Uncertainty

- **Classic distinction** — Economist Frank Knight separated measurable **risk** from unmeasurable **uncertainty**.
- **Knightian uncertainty** — A situation where probabilities cannot be reliably assigned.
- **Practical meaning** — Risk can be priced and capitalised; uncertainty needs buffers, scenarios and judgement.

Basis	Risk	Uncertainty
Probabilities	Known or estimable from data	Unknown or not estimable
Measurement	Expected loss, VaR, default rates	No reliable measure
Management	Priced, provisioned, capitalised, insured	Stress scenarios, buffers, contingency plans
Example	Default rate of a seasoned gold-loan book	Loss from a new kind of AI-driven fraud

- **Moving boundary** — As data build up, some uncertainty becomes measurable risk.
- **Rare extremes** — Rare, extreme and unforeseen events lie in the tail and need stress testing.
- **Operational risk** — It has a large uncertainty component because severe events are rare and keep changing.

Remember this

- Risk = **measurable** uncertainty (probabilities known); uncertainty = probabilities **not known**.

Topic 4 — Elements of Risk

Risk can be broken into elements that a bank can identify, measure and control.

Element	Meaning	Bank example
Objective	What the bank wants to achieve	Profit target; 24x7 payment service
Source (hazard)	A condition that can give rise to loss	Weak password policy; over-leveraged borrower
Event (peril)	The occurrence that causes the loss	Account takeover; borrower default
Exposure	Amount or activity at stake	Loan outstanding; daily payment value
Likelihood	Probability of the event in a period	2% chance in a year