

Risk Management in Banking

Risk Management in Banking – Structured Study Notes

1. Overview

Aspect	Description
Definition	The process of identifying, measuring, monitoring, and controlling risks that could affect a bank's financial health, reputation, and regulatory compliance.
Purpose	Protect capital, ensure liquidity, maintain profitability, and satisfy regulators and stakeholders.
Key Principle	<i>Risk and return are inseparable</i> – higher risk should be compensated by higher expected return, but risk must stay within the bank's risk appetite.

2. Types of Risks in Banking

Risk Category	Core Elements	Typical Metrics
Credit Risk	Default of borrowers, downgrade of counterparties, concentration risk.	Probability of Default (PD), Loss? Given Default (LGD), Exposure at Default (EAD), Expected Credit Loss (ECL).
Market Risk	Changes in market prices, rates, and volatilities affecting trading books and banking book positions.	Value?at?Risk (VaR), Stress VaR, Sensitivity (Delta, Gamma), Earnings at Risk (EaR).
Liquidity Risk	Inability to meet cash?flow obligations without unacceptable losses.	Liquidity Coverage Ratio (LCR), Net Stable Funding Ratio (NSFR), Cash ?flow gap analysis.
Operational Risk	Failures of processes, people, systems, or external events (e.g., fraud, cyber?attack).	Frequency?Severity models, Key Risk Indicators (KRIs), Scenario analysis.
Interest?Rate Risk in the Banking Book (IRRBB)	Mismatch between assets and liabilities due to rate changes.	Economic Value of Equity (EVE), Net Interest Income (NII) simulations.

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Risk Category	Core Elements	Typical Metrics
Compliance / Legal Risk	Breaches of laws, regulations, or internal policies.	Number of regulatory breaches, fines, remediation costs.
Reputational Risk	Damage to brand or stakeholder trust.	Media sentiment scores, customer complaint trends.
Strategic Risk	Poor business decisions, misaligned strategy, competitive pressures.	Scenario planning outcomes, KPI variance analysis.

3. Risk Governance Framework

1. Board of Directors

- Sets overall risk appetite and tolerance.
- Reviews risk-adjusted performance.

2. Risk Committee (Board Level)

- Oversees risk policies, capital adequacy, and major risk exposures.

3. Chief Risk Officer (CRO) & Risk Management Function

- Implements risk policies, develops measurement models, and reports to the board.

4. Business Line Heads

- Own risk within their portfolios; ensure adherence to limits.

5. Internal Audit

- Independent verification of risk controls and processes.

6. Regulatory Oversight

- Basel III/IV standards, local supervisory expectations, stress-testing mandates.
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4. Core Risk Management Processes

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Step	Description	Typical Tools
Risk Identification	Capture all material risk sources through workshops, data mining, and external alerts.	Risk registers, risk taxonomy, scenario catalogues.
Risk Measurement & Quantification	Assign numeric values to risk exposures.	Credit scoring models, VaR engines, Monte Carlo simulations, rating-based PD/LGD models.
Risk Monitoring	Ongoing tracking against limits and thresholds.	Dashboards, real-time limit breach alerts, KRIs.
Risk Control & Mitigation	Apply hedging, diversification, collateral, insurance, and	