

Introduction to Risk Management in Banking

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Key concepts, categories, and the typical framework used by banks

1. Why Risk Management Matters in Banking

Reason	Explanation
Financial stability	Protects the bank's capital and liquidity, preventing failures that could affect the whole financial system.
Regulatory compliance	Authorities (e.g., Basel III, local banking supervisors) require banks to identify, measure, and control risks.
Customer confidence	Robust risk practices reassure depositors, borrowers, and investors.
Profitability	Proper risk-adjusted pricing and capital allocation improve returns on equity.
Strategic decision-making	Enables informed choices about new products, markets, and growth initiatives.

2. Core Risk Types in Banking

Risk Category	Definition	Typical Measurement Tools
Credit Risk	Potential loss from a borrower's failure to meet contractual obligations.	- Probability of Default (PD) - Loss Given Default (LGD) - Exposure at Default (EAD) - Credit scoring models
Market Risk	Losses arising from movements in market prices (interest rates, FX, equities, commodities).	- Value at Risk (VaR) - Expected Shortfall (ES) - Stress testing

Introduction to Risk Management in Banking

Risk Category	Definition	Typical Measurement Tools
Liquidity Risk	Inability to meet cash flow needs without unacceptable losses.	• Liquidity Coverage Ratio (LCR) • Net Stable Funding Ratio (NSFR) • Cash flow gap analysis • Scenario analysis
Operational Risk	Losses from inadequate or failed processes, people, systems, or external events.	• Loss data collection (internal & external) • Key Risk Indicators (KRIs) • Earnings at Risk
Interest Rate Risk in the Banking Book (IRRBB)	Sensitivity of earnings and economic value to changes in interest rates.	• Economic value of Equity (EVE) • Regulatory reporting dashboards
Legal & Compliance Risk	Exposure to fines, penalties, or reputational damage due to non-compliance.	• Compliance risk assessments • Media monitoring
Reputational Risk	Potential loss of stakeholder trust and business value.	• Stakeholder surveys • Incident tracking

3. The Risk Management Framework (RMF)

3.1 Governance Structure

1. **Board of Directors** – Sets risk appetite, approves policies, oversees the overall RMF.
2. **Risk Committee** – Monitors risk exposures, ensures alignment with appetite.
3. **Chief Risk Officer (CRO) & Risk Management Division** – Designs, implements, and reports on risk controls.
4. **Business Units** – Own day-to-day risk identification and mitigation within their scope.

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5. Audit & Compliance – Independent verification of risk processes.

3.2 Key Steps in the RMF

Step	Description	Typical Outputs
Risk Identification	Capture all material risks across the bank's activities.	Risk registers, risk maps
Risk Measurement & Quantification	Assign numeric values (e.g., VaR, PD, LCR).	Risk metrics, capital allocation models
Risk Monitoring & Reporting	Ongoing tracking against limits and thresholds.	Dashboards, periodic risk reports
Risk Control & Mitigation	Implement policies, limits, hedges,	