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B.COM HONOURS	SEMESTER 6	CALICUT UNIVERSITY	COURSE CODE: COM6EJ304

RISK MANAGEMENT IN BANKS AND INSURANCE

EXAM REVISION NOTES

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MODULE I

FOUNDATIONS OF RISK, COST OF RISK, AND RISK MANAGEMENT FRAMEWORKS

The Concept and Nature of Risk: In financial literature, Risk is formally defined as the condition in which there is a possibility of an adverse deviation from a desired or expected outcome.

Degrees of Risk and Mathematical Formulation: The Degree of Risk refers to the intensity or magnitude of uncertainty inherent in a given exposure situation.

Cost of Risk: Components and Total Cost Optimization: Risk is not merely an abstract statistical concept; it imposes a substantial, measurable financial drag on business organizations and society.

Sources and Comprehensive Taxonomies of Risk: To implement effective control mechanisms, risk managers classify risks across standardized operational categories based on their nature, predictability, and financial outcomes.

- **Outcome Potential:** Pure Risk: Situations that hold only two possible outcomes: a financial loss or no loss (zero gain).
- **Economic Origin:** Static Risk: Connected to perils of nature (storms, floods) or human dishonesty (fraud, arson, vandalism).
- **Systemic Reach:** , war, severe inflation, systemic financial crises, pandemics).
- **Organizational Tolerability:** ; Non-Acceptable (Unacceptable) Risk: Severe risks that exceed corporate balance-sheet absorption capacity or violate statutory mandates, requiring mandatory avoidance, elimination, or full risk transfer.

Risk Management: Evolution, Principles, and Strategic Significance: Risk Management is the formal, systematic executive process of identifying, analyzing, evaluating, and controlling exposures to loss, and selecting the most operationally and financially effective methods for treating them to ensure corporate survival and strategic continuity.

Core Characteristics of Risk Management

The Dual Objectives of Risk Management: Pre-Loss vs. Post-Loss: To provide balanced organizational direction, risk management establishes distinct objectives classified chronologically based on whether a catastrophic loss has yet occurred.

The Risk Management Process: A Five-Stage Sequential Architecture: The execution of effective risk management follows a standardized, logical five-stage process that systematically transforms unknown hazards into controlled, financed operational parameters.

Risk Avoidance

Loss Control: Prevention vs. Reduction

Risk Financing: Retention vs. Transfer

The Risk Evaluation Matrix: Frequency and Severity Grid: The cornerstone tool used by risk managers to select the appropriate treatment strategy is the Risk Evaluation Matrix (Probability-Impact Grid).

- **Low Frequency (Rare Occurrence):** Strategy: RETENTION Characteristics: Minor office supply theft, minor scratch on fleet car, occasional tool breakage.
- **High Frequency (Frequent Occurrence):** Strategy: LOSS CONTROL RETENTION Characteristics: Minor retail shoplifting, routine worker slip-and-fall incidents, postal delivery damage.

Structure of a Corporate Risk Management Policy Statement: A Risk Management Policy Statement is the formal foundational document endorsed by the Board of Directors that codifies the organization's philosophy toward risk.

- **1. Statement of Intent and Objectives:** Clearly stating that the firm commits to identifying and mitigating hazards to ensure organizational solvency and operational continuity.
- **2. Risk Appetite and Tolerance Guidelines:** , maximum unhedged loss capped at 2% of annual operating profit).
- **3. Delineation of Authority:** Specifying delegated financial limits for purchasing insurance, settling liability claims, or approving risky capital projects.
- 4.
- **5. Policy Review Cycle:** Mandating an annual review by the Board Risk Committee to adapt to emerging market conditions and regulatory changes.

Comprehensive Foundational Review Matrix

- **Risk vs. Uncertainty:** ; Insurance companies write policies exclusively on quantifiable risk (mortality, fire); entrepreneurs absorb true uncertainty.
- **Law of Large Numbers:** ; Allows insurance underwriters to accurately price life and general insurance premiums and minimize solvency reserve capital.
- **Cost of Risk (TCOR):** ; Corporations benchmark total cost of risk (TCOR) as a percentage of gross revenue to evaluate the efficiency of their risk programs.
- **Pure vs. Speculative:** ; Pure risks are transferred via commercial insurance contracts; speculative risks are managed via capital structure, portfolio diversification, and financial derivatives.

Empirical Casework: Forensic Analysis, Audit Trail Verification, and Internal Controls: Empirical accounting investigations across modern industrial enterprises illustrate that financial distortion, fraud, and misstatement rarely occur as isolated incidents; rather, they stem from structural vulnerabilities within accounting workflows, segregation-of-duties lapses, or inadequate internal audit scrutiny.

- **Ledger amp; Voucher Integrity:** ; Companies Act (Sec.
- **Revenue amp; Cost Allocation:** ; Ind AS 115 (Revenue from Contracts with Customers) amp; CAS 1 to 24 Cost Accounting Standards.
- **Fiscal Risk amp; Tax Compliance:** ; GST Law Section 16/36 Rules amp; Income Tax Act Transfer Pricing Provisions.
- **Working Capital Governance:** ; Tandon amp; Chore Committee Norms for Bank Working Capital Credit Appraisal.

Comparative Regulatory and Practical Implementation Standards: A rigorous examination of corporate commercial practice highlights the indispensable role of standardized accounting principles.

MODULE II

RISK MANAGEMENT IN BANKS: TAXONOMY, ALM FRAMEWORKS, AND REGULATORY ARCHITECTURE

Comprehensive Taxonomy of Risks in Banking Institutions: In modern banking science, risks are categorized based on their underlying financial, contractual, and operational sources into eight primary dimensions:

Market Risk (Price Risk)

Liquidity Risk

Currency / Foreign Exchange Risk

Country Risk (Transfer Risk)

Assets and Liabilities Management (ALM) in Banks: Asset-Liability Management (ALM) is a dynamic financial risk management framework deployed by commercial banks to coordinate, plan, and direct balance-sheet allocations, managing the size, maturity, duration, interest rate sensitivity, and liquidity profile of assets and liabilities to achieve stable earnings and preserve long-term solvency.

Dual Core Objectives of ALM

Interest Rate Sensitivity: Repricing Gap and Duration Gap: Banks evaluate Interest Rate Risk in the Banking Book using two primary analytical models: Repricing Gap Analysis and Duration Gap Analysis.

The Prompt Corrective Action (PCA) Framework of RBI: The Prompt Corrective Action (PCA) framework is a specialized supervisory intervention mechanism instituted by the Reserve Bank of India under the Banking Regulation Act, 1949.

Key Credit Rating Agencies in India

Credit Rating Methodology: Qualitative and Quantitative Criteria

- **1. Business Risk Analysis:** Industry characteristics, cyclicity, market share, competitive barriers to entry, technological vulnerability, and customer concentration.
- **2. Financial Risk Analysis:** 0x), Cash Flow from Operations, and working capital liquidity.
- **3. Management Governance Evaluation:** Integrity of promoters, track record of corporate governance, audit quality, transparency of disclosures, and strategic vision.
- **4. Sovereign Macroeconomic Factors:** Foreign currency exposure, regulatory risks, sovereign support assumptions, and macroeconomic shocks.

Stress Testing, Reverse Stress Testing, and Catastrophic Modeling: Because VaR models are calibrated on historical data and fail to predict extreme "black swan" tail events, the RBI mandates comprehensive Stress Testing and Scenario Analysis.

Forward Contracts FRAs

Options (Caps, Floors, Collars)

Comprehensive Synthesis Review Matrix

- **Credit Risk Management:** Measured via Expected Loss (PD × LGD × EAD).
- **Asset-Liability Management (ALM):** Governed by ALCO.
- **Basel III Capital Adequacy:** ; Forces banks to maintain robust equity cushions and unencumbered liquid government securities (HQLA) to withstand systemic panics.
- **Prompt Corrective Action (PCA):** ; Imposes automatic curbs on dividend distribution, branch expansion, high-risk lending, and executive bonuses to restore financial health.

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MODULE III

RISK MANAGEMENT AND TOOLS IN INSURANCE: PERSONAL RISK, HEALTHCARE, AND ESTATE PLANNING

Foundational Architecture of Insurance and Insurability Principles: From an economic standpoint, Insurance is a financial device whereby a large number of individuals and business entities facing similar risk exposures pool their funds together, transferring their individual risks of catastrophic loss to a professional risk-bearing entity (the insurer).

The Principle of Risk Pooling

The Seven Requirements of an Ideally Insurable Risk: Not all risks can be covered by commercial insurance contracts. For a risk to be commercially insurable from an actuarial and underwriting standpoint, it must satisfy seven stringent criteria:

- **1. Large Number of Homogeneous Units:** ; Enables the Law of Large Numbers to operate effectively, allowing actuaries to accurately forecast aggregate expected losses and price premiums.
- **2. Accidental Fortuitous Loss:** ; Eliminates Moral Hazard.
- **3. Determinable Measurable Loss:** ; Prevents fraudulent disputes over whether a covered event actually transpired and enables objective calculation of the exact indemnity payable.
- **4. Non-Catastrophic Loss to Insurer:** ; Guarantees insurer solvency.

Fundamental Legal Doctrines Governing Insurance Contracts: Because insurance involves the forward sale of an intangible financial promise, insurance policies are governed by specialized legal doctrines established under common law and codified in statutes like the Insurance Act, 1938 and the Marine Insurance Act, 1963.

Identifying Personal Risk Exposures

Measuring Frequency and Severity

Risk Management Applications: Loss of Life (Life Insurance Analytics): The economic value of human life stems from the capacity of an individual to generate future economic income for the benefit of dependents.

Comprehensive Taxonomy of Life Insurance Products

- **Term Life Insurance:** Pure mortality protection for a specified tenure (10, 20, 30 years).
- **Whole Life Insurance:** Provides permanent guaranteed protection until death (or age 100).
- **Endowment Assurance:** Combines mortality protection with savings.
- **Unit Linked Insurance Plans (ULIPs):** ; Suitable for investors seeking life cover combined with long-term capital appreciation, featuring tax benefits under Section 80C/10(10D) subject to statutory limits.

Indemnity Health Plans (Mediclaim)

Key Contractual Clauses in Health Insurance

- **Deductibles and Co-payments:** A deductible is the initial fixed rupee amount the insured must pay out-of-pocket before insurance coverage kicks in.
- **Pre-Existing Disease (PED) Waiting Period:** Medical conditions diagnosed prior to policy issuance are excluded from coverage for a statutory waiting period (mandated by IRDAI as maximum 36 months in recent regulations), after which they become fully covered.
- **Room Rent Caps and Proportionate Deductions:** , capped at 1% of Sum of insured per day), insurers apply proportionate deductions across all associated medical fees (doctor fees, surgery charges).
- **No-Claim Bonus (NCB):** A reward for claim-free policy years, increasing the Sum of insured by 10% to 50% without any increase in premium payable.

Retirement Planning, Superannuation, and Annuities: Modern demographic shifts and medical advancements have substantially lengthened human life expectancy. While extended longevity is a human triumph, it introduces severe Longevity Risk: the probability that an individual will survive long after their active income-earning years, completely exhausting their accumulated savings and plunging into old-age financial dependency.

- **Life Annuity (Straight Life):** ; Highest payout rate: Entire capital is pooled.
- **Life Annuity with Return of Purchase Price (ROP):** ; Lower annuity payout yield compared to straight life, but preserves family capital for legal heirs.
- **Joint Life / Last Survivor Annuity:** ; Guarantees that a surviving dependent spouse is never left without income, regardless of which partner survives longer.
- **Guaranteed Period Annuity (Term Certain):** ; If annuitant dies in year 3 of a 10-year term, payouts continue to beneficiaries for the remaining 7 years.

Group Term Life Insurance (GTLI)

Group Health Personal Accident

Comprehensive Synthesis Review Matrix

- **Legal Principles of Insurance:** ; Governs claim settlements, prevents moral hazard and fraud, and guarantees legal enforceability of insurance contracts.
- **Human Life Value (HLV):** ; Provides an objective, mathematically sound basis for determining appropriate term life insurance coverage.
- **Health Disability Insurance:** ; Protects household investment portfolios from being liquidated during sudden medical emergencies.
- **Annuity Contracts:** ; Core decumulation instrument under pension schemes (NPS), shielding retirees from outliving their financial assets.

Advanced Analytical Dimensions and Applied Commerce Casework (Analytical Division 1): The concepts, statutory provisions, operational accounting rules, and quantitative models detailed in this module carry critical implications for enterprise governance, audited disclosure standards, and executive fiscal decision-making.

Comparative Regulatory and Practical Implementation Standards: A rigorous examination of corporate commercial practice highlights the indispensable role of standardized accounting principles.

MODULE IV

COMMERCIAL RISK MANAGEMENT APPLICATIONS, INSURER OPERATIONS, AND REGULATORY GOVERNANCE

Commercial Property Risk Management: Direct vs. Consequential Losses: Commercial property exposures encompass all physical and tangible assets owned, leased, or utilized by an enterprise in its commercial operations.

Direct Physical Loss

Core Commercial Property Insurance Contracts

The Condition of Average (Under-Insurance Penalty): A fundamental underwriting rule in commercial property insurance is the Condition of Average. If, at the time of a loss, the property is insured for a Sum of less than its true realisable value (under-insurance), the policyholder is legally considered as being their own insurer for the difference, and must bear a proportionate share of the loss.

Comprehensive Taxonomy of Commercial Liability Policies

- **1. Commercial General Liability (CGL):** ; Covers two operational facets: (a) Premises amp; Operations (injuries occurring on factory/office premises), and (b) Products amp; Completed Operations (harm caused by goods manufactured or services concluded).
- **2. Public Liability Insurance Act, 1991:** ; Provides immediate relief to victims of industrial accidents without requiring proof of negligence.
- **3. Product Liability Insurance:** ; Covers manufacturing defects, design flaws, and failure to warn (inadequate labeling).
- **4. Professional Indemnity (E amp;O):** ; Covers financial losses suffered by clients resulting from negligent advice, design errors, auditing omissions, or breach of professional duty of care.

Workers' Compensation and Employer Risk Financing: Human capital represents the engine of enterprise productivity. However, industrial operations inherently expose workers to mechanical, chemical, biological, and ergonomic hazards.

Underwriting Function

Actuarial Function

Marketing Distribution

Government Regulation of the Insurance Sector IRDAI: Because insurance involves public trust and the management of trillions in policyholder savings, the insurance industry is subject to comprehensive sovereign statutory regulation in India under the Insurance Regulatory and Development Authority of India (IRDAI), established pursuant to the IRDAI Act, 1999.

Consumer Protection The Insurance Ombudsman Scheme: To provide a cost-effective, expeditious, and impartial mechanism for resolving individual policyholder grievances against insurance companies, the Government of India instituted the Insurance Ombudsman Scheme under the Redressal of Public Grievances Rules.

- **Jurisdiction Scope:** ; Entertains complaints regarding: total/partial repudiation of claims, dispute over premium paid, delay in settlement, and non-issuance of policy documents.
- **Pecuniary Ceiling:** ; Covers disputes where the total claim compensation sought (including ex-gratia) does not exceed INR 30 Lakhs.
- **Cost and Process:** ; No court fees or advocate representation required.
- **Legal Nature of Award:** ; The insurer must implement the Ombudsman's award within 30 days.

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Executive Synthesis, Governance Policy, and Continuing Professional Mastery: To conclude, mastery of the concepts examined throughout this module empowers students and commerce executives to evaluate complex fiscal data with precision, independence, and analytical clarity.

Advanced Analytical Dimensions and Applied Commerce Casework (Analytical Division 2): The concepts, statutory provisions, operational accounting rules, and quantitative models detailed in this module carry critical implications for enterprise governance, audited disclosure standards, and executive fiscal decision-making.

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