FINAL EXAMINATION SET 1

MODEL QUESTION PAPER TERM – JUNE 2023

PAPER – 20B

# RISK MANAGEMENT IN BANKING AND INSURANCE

**Time Allowed: 3 Hours** **Full Marks: 100**

The figures in the margin on the right side indicate full marks.

Where considered necessary, suitable assumptions may be made and clearly indicated in the answer.

## SECTION – A : Risk Management in Banking

Answer Question No. 1 and 6 are compulsory; Answer any three from Question No. 2, 3, 4 & 5.

1. (a) **Choose the correct alternative. Provide justification in each case. 1 mark is allotted for correct selection and 1 mark for the justification.: [8 × 2 = 16]**

(i) Which of the following is Not a type of risk in Banking Sector and why?

a. Credit Risk.

b. Operational Risk.

c. Market Risk.

d. Account Risk.

(ii) Operational Risk is the Risk of---------. Please justify your selection.

a. When borrowers or counterparties fail to meet contractual obligations.

b. The unpredictability of equity markets, commodity prices, interest rates, and credit spreads.

c. Loss due to errors, interruptions, or damages caused by people, systems, or processes.

d. The ability of a bank to access cash to meet funding obligations.

(iii) When the risk of losses in on- or off-balance sheet positions arise from movement in market prices, it is called as------------. Briefly justify your selection.

a) Credit Risk.

b) Operational Risk.

c) Market Risk.

d) Liquidity Risk.

(iv) "Payments credited to the wrong account" is an example of which Risk and why?

a) Credit Risk.

b) Operational Risk.

c) Market Risk.

d) Liquidity Risk.

(v) The risk that arises from the possibility of non-payment of loans by the borrowers is known as-----------. Please justify your selection.

a) Credit Risk.

b) Market Risk.

c) Moral Hazard.

d) Liquidity Risk.

(vi) __________ risk arises because of the fact that the financial system is one intricate and connected network. Please justify your selection.

a) Credit.

b) Operational.

c) Market Risk.

d) Systemic.

(vii) The major component of Market risk is ---------. Please justify your selection.

a) Interest Rate Risk.

b) Equity Risk.

c) Foreign Exchange Risk.

d) All of the above.

(viii) When bank's image and public standing is in doubt and leads to public's loss of confidence in a bank, it is called as ----------. Please justify your selection.

a) Reputational Risk.

b) Moral Hazard.

c) Operational Risk.

d) Market Risk.

2. (a) What is a Sovereign Risk? Explain in brief the sources of Sovereign Risk.

(b) "The Capital Adequacy Ratio (CAR) is a measurement of a Bank's available Capital expressed as a percentage of a Bank's Risk-weighted Credit Exposures. This is required to protect depositors and promote the stability and efficiency of financial systems of the sovereign financial ecosystem and the world at large." Do you agree with the above statement. Demonstrate veracity of the above statement and provide logics behind your opinion supported by recent events from banking ecosystem and the relevant instructions and policy guidelines. **[4+8=12]**

3. (a) Illustrate with example, the various sources of interest rate risk. Relate the impact of the interest rate risk with financial performance of a bank.

(b) (i) Demonstrate with examples, the different types of 'Market Risk' involved in banking business.

(ii) Are 'Counter Party Risk' and 'Country Risk' related to each other? Elucidate your answer with example. **[6 + 6 = 12]**

4. (a) Analyze the underlying reasons for increasing importance of credit risk modelling? Examine the forms in which credit risk arises for banks?

(b) In the measurement of Credit Risk, models may be classified into three different dimensions. Inspect these dimensions and briefly state your views thereon.

**[(4+4)+4=12]**

5. (a) Briefly analyze the concept of Operational Risk? Examine the types of Operational Risk as identified by Basel Committee.

(b) Assess the Composition of Regulatory Capital. Suggest the minimum regulatory capital requirement for Banks in India as per Basel III Accord? **[4 + 8 = 12]**

6. Tier-I Capital Funds, Tier-II Capital Funds, RWAs for Credit Risk, Capital Charge for Market Risk and Capital Charge for Operational Risk is to be assessed in accordance with the guidelines of Basel Committee recommendations in Banks.

Capital Charge for Market Risk and Capital Charge for Operational Risk is converted into equivalent Risk Weighted Assets by dividing them by 0.09 to Compute RWAs for Market Risk and RWAs for Operational Risk.

Tier-I CRAR and total CRAR is computed using following formulae.

Tier-I CRAR is computed as:

(Eligible Tier I Capital Funds) ÷ (RWAs for Credit Risk + RWAs for Market Risk + RWAs for Operational Risk)

Total CRAR is Computed as:

(Eligible Total Capital Funds) ÷ (RWAs for Credit Risk + RWAs for Market Risk + RWAs for Operational Risk).

Based on the above information, answer the following Question:

A bank has Computed its Tier I Capital- ₹ 1,400 Crores (Inclusive of CET1 + AT1) Tier-II Capital -₹ 1,200 Crores

RWAs for Credit Risk-₹ 10,000 Crores

Capital Charge for Market Risk-₹ 500 Crores

Capital Charge for Operational Risk-₹ 300 Crores

Formulate and determine Bank's Tier-I CRAR and Total CRAR and give your comments with advices for the banks to consider. **[8]**

## SECTION – B : Risk Management in Insurance

Answer Question No. 7 and 11 are compulsory; Answer any two from Question No. 8, 9 & 10.

7. **Choose the correct alternative. Provide justification in each case. 1 mark is allotted for correct selection and 1 mark for the justification.:**

(i) The following is the similarity between insurance and gambling ------------. Please justify your selection.

a. Promise to pay on the happening of an event.
b. The amount of loss to be paid is known beforehand.
c. Both the parties win on happening of an event.
d. Both are enforceable at law.

(ii) In which of the following is the principle of indemnity applicable and why?

a. All types of insurances.
b. Non-life insurance only.
c. Life insurance only.
d. Either (b) or (c) above. **[2×2=4]**

8. (a) "It is the duty of the proposer to disclose, clearly and accurately, all material facts relating to the proposed insurance."
Demonstrate the facts that are to be disclosed by the proponent as well as the facts that need not be while taking coverage for various risks in general.

(b) Discuss the reasons why free look period is important in the context of insurance?
**[10 + 4 = 14]**

9. (a) What are the basic requirements of an Insurance Contract?

(b) Analyze the importance of insurable interest in every insurance contract. Elucidate your answer with suitable examples. **[6 + 8 = 14]**

10. (a) Analyze the difference between pure risk and speculative risk.

(b) Recommend with justification the process of Risk Assessment. **[6 + 8 = 14]**

11. Govind Rao, a dealer in timber, supplied timber to companies on a contract basis. He insured his business with Unity Insurance Company. Govind Rao had different payment arrangements with each of his clients. While some clients were asked to pay in cash, others were allowed credit.

Green Earth Public Ltd was one of the companies that purchased timber from Govind Rao. Govind Rao received fully paid shares of the company as payment for the timber sold to it. By financing the company during its time of need, Govind Rao had also become an unsecured creditor of the company.

On 10 April 2022, Govind Rao and Green Earth signed a deal for 1000 teak wood logs. The delivery of the timber was to take place the next day. Unfortunately, that night there was a short circuit at the godown where the timber was stored, and the entire consignment was destroyed in the fire. Govind Rao filed a claim with the insurance company for the loss he had incurred. Unity, however, rejected his claim and refused to pay for the loss, alleging that the timber which was destroyed was sold by the insured to Green Earth and, therefore, Govind Rao no longer had any claim over it.

Critically analyse the facts of the case and answer the following:

a. Is Govind Rao entitled to receive compensation from the insurance company for the loss caused by the fire?

b. What is insurable interest in the above example? Advise Mr. Govind Rao whether he is entitled to recover the compensation for the loss due to fire. Formulate a set of justification in support of your answer. Do you think whether the insurance company can refuse to entertain the claim? **[4 + 4 = 8]**