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RESERVE BANK OF INDIA

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Guidance Note on Market Risk Management

Table of Contents

Chapter-I Preliminary

A. Introduction

1. Market risk is defined as the risk of losses arising from movements in market prices. It refers to the risk to a bank's earnings and capital resulting from changes in interest rates, prices of securities, foreign exchange rates, and equity prices, as well as from the volatilities associated with these changes. Accordingly, it is imperative that a bank has a robust Market Risk Management system that is sensitive and responsive to these factors. This Guidance Note focuses on the management of Market Risk in the bank.

B. Applicability

2. This Guidance Note shall be applicable to Commercial Banks.

For the purpose of these Directions, 'Commercial Banks' means banking companies (including Small Finance Banks, Payment Banks, and Local Area Banks), corresponding new banks, and the State Bank of India, as defined respectively under clauses (c), (da), and (nc) of Section 5 of the Banking Regulation Act, 1949 ('BR Act').

Chapter-II Policy Framework

3. An effective market risk management framework in a bank comprises risk identification, setting up of limits and triggers, risk monitoring, use of models to value positions or measure market risk, risk reporting, etc.

A. Risk Identification

4. A bank shall put in place an approved Market Risk Product Programme, which should define the procedures, limits, and controls for all aspects of the product. New products may operate under a Product Transaction Memorandum on a temporary basis while a full Market Risk Product Programme is being prepared. At the minimum this should include procedures, limits, and controls. The final product transaction program should include market risk measurement at the individual product and aggregate portfolio level.

Limits and Triggers

5. All trading transactions shall be booked on systems capable of accurately calculating the relevant sensitivities on a daily basis. Sensitivity and Value at Risk limits for trading portfolios shall be measured daily. Where market risk is not measured daily, Risk Taking Units must have procedures that monitor activity to ensure that they remain within approved limits at all times.

6. Market risk limits shall be established for factor sensitivities and Value at Risk for all mark to market trading activities. The Action Triggers or Stop-loss limits approved by the Top Management shall also be prescribed for all mark to market trading activities. Requests for such limits shall be submitted annually for approval by the Risk Management Committee (RMC). While approving these limits, the Committee shall take into consideration the front office's capacity and capability to operate within those limits, adequacy of controls and risk management, audit ratings, and trading revenues. Furthermore, the front office is expected to apply additional and appropriate market risk limits, including limits for basis risk, to the products involved. These limits shall be documented in the Market Risk Product Programme.

B. Risk Monitoring

7. A rate reasonability process shall be in place to ensure that all transactions are executed and revalued at prevailing market rates. The rates used at inception or for

periodic marking to market for risk management or accounting purposes shall be independently verified.

8. Models used for revaluations for income recognition purposes or for measuring or monitoring Price Risk shall be independently tested and certified.

9. Stress tests shall be conducted, for both trading and banking book portfolios, preferably on a quarterly basis, or when the underlying assumptions of the model / market conditions significantly change as decided by the Asset Liability Committee (ALCO).

C. Models Governance and Validation

10. A bank shall ensure that the models used to value positions or measure market risk perform calculations accurately.

11. The RMC shall be responsible for administering the model control and certification policy.

12. Models shall be fully documented, and minimum standards of documentation shall be established.

13. Assumptions used in the Models shall be documented as part of the initial certification and reviewed annually.

14. The bank shall ensure independent validation of the models used for valuation or market risk measurement.

15. Models used to calculate risk measures like sensitivities to market factors and Value-at-Risk shall be validated independently.

16. The assumptions used in the model shall be subject to periodic review to ensure their continued applicability and to confirm that they remain appropriate for their intended use. Such review shall include an assessment of components of the model and the underlying assumptions.

D. Risk Reporting

17. Risk reporting should enhance communication across all levels of the bank, from the trading desk to the CEO. The reports should be timely, reasonably accurate, highlight portfolio risk concentrations, include written commentary, and remain concise.

Chapter-III Organisational Set Up

18. Management of market risk should be a key area of focus for Top Management of a bank. The Board shall clearly articulate the market risk management policies, procedures, prudential risk limits, review mechanisms, reporting, and auditing systems. The policies should address the bank's exposure on a consolidated basis and specify the risk measurement systems that capture all material sources of market risk. The operating prudential limits and accountability of the treasury officials shall also be clearly defined. The ALCO should function as the top operational unit for managing the Balance Sheet within the performance / risk parameters laid down by the Board.

19. Successful implementation of any risk management process must emanate from the Top Management in the bank with the demonstration of its strong commitment to integrate basic operations and strategic decision making with risk management. Ideally, the organisation set up for Market Risk Management should be as under:

- Board of Directors (Board)
- Risk Management Committee (RMC)
- Asset-Liability Management Committee (ALCO)
- Market Risk Group / Middle Office

20. The Board shall have the overall responsibility for management of risks. The Board shall decide the risk management policy of the bank and set limits for liquidity, interest rate, foreign exchange, and equity price risks.

21. The RMC shall be a Board level Sub-committee and its members may include CEO, CRO, and heads of Credit, Market, and Operational Risk Management Committees. The RMC shall decide the policy and strategy for integrated risk management containing various risk exposures of the bank including market risk. The responsibilities of RMC with regard to market risk management include:

(i) Setting policies and guidelines for market risk measurement, management, and reporting;

(ii) Ensuring that market risk management processes (including people, systems, operations, limits, and controls) satisfy the bank's policy;

(iii) Reviewing and approving market risk limits, including triggers or stop-losses for trading and banking book portfolios;

(iv) Ensuring robustness of models, and the effectiveness of all systems used to calculate market risk; and

(v) Appointment of qualified and competent staff and ensuring the posting of qualified and competent staff, including independent market risk manager/(s)., etc.

22. The ALCO shall be responsible for ensuring adherence to the limits set by the Board, as well as for deciding the business strategy of the bank in line with bank's risk appetite. The Middle Office is responsible for the critical functions of independent market risk monitoring, measurement, analysis, and reporting to the bank's ALCO. An effective Middle Office provides the independent risk assessment which is critical to ALCO's key function of controlling and managing market risks in accordance with the mandate established by the Board / RMC. The Middle Office staff may prepare forecasts (simulations) showing the effects of various possible changes in market conditions related to risk exposures. A bank using VaR or modelling methodologies should ensure that its ALCO is aware of and understand the nature of the output, how it is derived, assumptions and variables used in generating the outcome and any shortcomings of the methodology employed. Segregation of duties should be evident in the middle office which must report to ALCO independently of the treasury function.

A. Dealing Room

23. Treasury Dealing Room shall function as the central unit for managing and controlling market risk within the bank. It provides funding, liquidity, and investment support for the bank's asset-liability profile. The Dealing Room also supports business units by providing appropriate pricing of market risks for application to its products and services.

24. The RMC may allocate a discretionary limit for proprietary risk-taking, within which the Dealing Room may undertake market risk positions on a proprietary basis.

25. For effective functioning, dealers shall have access to a comprehensive Dealing Room manual covering all aspects of their day-to-day activities. Dealers shall acknowledge in writing their familiarity with, and adherence to, the bank's dealing

guidelines and procedures. Dealing Room procedures manual shall be comprehensive and shall set out the operating procedures for all trading activities undertaken by the Dealing Room, including the bank's requirements in respect of:

(i) **Code of Conduct -** All dealers must acknowledge familiarity with, and provide an undertaking to adhere to, code of conduct prescribed by FEDAI and FIMMDA.

(ii) **Adherence to Internal Limits -** All dealers shall acknowledge and provide an undertaking to adhere to the internal limits governing their authority to assume risk, commensurate with their responsibilities and level of seniority.

(iii) **Adherence to RBI limits and guidelines** - All dealers shall acknowledge and undertake to comply with applicable RBI limits and guidelines relevant to their area of activity.

(iv) **Dealing with Brokers** - All dealers shall acknowledge and undertake to comply with the bank's guidelines governing dealings with brokers, including:

a) transacting only with brokers authorised by RMC and included in the bank's approved Brokers' Panel;

b) ensuring brokers act strictly as intermediaries and not as principals;

c) ensuring broker notes and confirmations of transactions are submitted to the Back Office before close of business each day or exceptionally by beginning of the next business day with appropriate marking and reconciled against transaction data; ensuring that all brokerage payments and statements are processed by the bank's Back Office and under no circumstances authorised or released by dealers;

d) prohibiting acceptance of gifts, gratifications, or favours from brokers,

e) prohibiting dealers from nominating a broker for transactions not executed through that broker; and

f) rules for prompt investigation of complaints against dealers and broker malpractices, and reporting to FEDAI / FIMMDA and the Department of Supervision, RBI.

(v) **Dealing Hours** - All Dealers shall be aware of the bank's designated trading hours, cut off time for overnight positions, and rules governing after hours and off-site trading, if permitted by the bank.

(vi) **Security and Confidentiality** - All dealers shall be aware of the bank's requirements in respect of maintaining confidentiality over its own and its customers' trading activities as well as the responsibility for secure maintenance of access credentials, keys, passwords, and PINs.

(vii) **Staff Rotation and leave requirements -** All dealers shall adhere to mandatory leave requirement, and the bank's internal policy in regard to staff rotation.

B. Back Office

26. The Back Office provides the primary control framework for market risk activities, particularly those arising from Dealing Room operations. To ensure robust governance, the bank shall maintain clear segregation of duties, independent reporting lines, and clearly defined physical and systems access control between Dealing Room and Back Office. The following critical Back Office controls must be executed diligently and comprehensively at all times:

(i) **Confirmations for both inward and outward transactions**: All confirmations for transactions executed by the Dealing Room must be issued and received by the Back Office only. Any discrepancies in transaction details, non-receipts of confirmations, or confirmations without corresponding application must be resolved promptly.

(ii) **Control over dealing accounts (Vostro and Nostro)** - Timely reconciliation of all dealing accounts is essential to ensure accurate identification and monitoring of risk exposures. Discrepancies, non-receipts, and receipts of funds without application must be resolved promptly. Persistent or material unreconciled items shall be escalated to Top Management as such discrepancies may have significant liquidity implications, unrecognised risk exposures, or indicate potential collusion or fraud.

(iii) **Independent Valuations and Mark-to-Market of exposures**: All market rates used for valuation, revaluation, or risk measurement (including VaR) must be sourced independently of the Dealing Room to ensure an independent risk and performance assessment.

(iv) **Monitoring and reporting of risk limits**: Utilisation of market-risk limits approved by the RMC must be monitored and reported independently of the Dealing Room. All limit systems (such as counterparty limits, overnight limits) must be securely maintained to prevent unauthorised access and tampering.

(v) **Control over payments systems**: The procedures and systems for making payments must operate under at least dual control within the Back Office. Payment systems should be secure at all times and protected against unauthorised access or tampering.

Chapter-IV Risk Management in Trading Book

A. Trading Book

27. The bank shall lay down policies governing the classification of securities in the trading book, including parameters such as volume, maximum maturity, holding period, duration, stop loss threshold, defeasance period, and minimum rating standards.

28. Securities held in the trading book shall be marked to market daily, and potential price risk arising from changes in market risk factors shall be measured using internally developed Value at Risk (VaR) models.

29. VaR method may be employed to assess the potential loss that could crystallise on a trading position or portfolio over a defined holding period, using a confidence level usually between 95 per cent to 99 per cent. The VaR method shall incorporate the relevant market risk factors against which the valuation of the trading position is exposed.

30. Top Management shall establish bank wide VaR limits for the trading portfolio (including forex and gold positions, derivative products, etc.). These limits shall be then disaggregated across different trading desks and business units. The bank shall also prescribe loss tolerance levels to ensure that potential adverse impact on earnings remains within acceptable thresholds. The Middle Office shall monitor the potential loss in Present Value Basis Points (PVBP), against approved prudential limits, on a daily basis.

31. VaR estimate must be validated through 'back testing'.

32. VaR may be supplemented with stress testing, which provides Top Management with an assessment of potential losses under severe market movements or tail-event scenarios.

33. Bank may also conduct scenario analysis, linking hypothetical, but plausible changes in multiple risk factors to assess their impact on the trading portfolio.

34. VaR models may be adjusted to reflect liquidity risk to characteristics of different assets.

B. Equity Position Risk Management

35. The bank shall establish a specific price risk framework (such as sensitivity limits, VAR limits, stop-loss limits) for management of equity position risk.

C. Foreign Exchange Risk Management

36. Foreign Exchange Risk is the risk that a bank may suffer losses as a result of adverse exchange rate movements during a period in which it has an open position, either spot or forward, or a combination of the two, in any foreign currency. The bank may also be exposed to interest rate risk arising from maturity mismatches in foreign currency positions. Even where spot and forward positions in currencies are balanced, the maturity pattern of forward transactions may produce mismatches. As a result, a bank may suffer losses due to changes in premia / discounts of the currencies concerned.

37. In the forex business, a bank also faces the risk of default of the counterparties or settlement risk. While such type of risk crystallisation may not lead to principal loss, bank may be required to undertake fresh transactions in the cash / spot market to replace the failed transactions, thereby incurring replacement cost that depends upon currency rate movements. A bank also faces time-zone risk or Herstatt risk which arises out of time-lags in settlement of one currency in one centre and the settlement of another currency in another time-zone. The forex transactions with counterparties from another country also trigger sovereign or country risk.

38. The key issues that need to be addressed in this regard are:

a. Nature and magnitude of exchange risk;

b. Strategy for hedging or managing exchange risk; and

c. Tools of managing exchange risk.

(1) *Nature and Magnitude of Risk:* Foreign exchange risk is inherent in all positions denominated in foreign currencies, and a bank must recognise and manage this risk to avoid adverse financial consequences. Measuring such risk requires understanding both accounting (translation) exposure and economic exposure driven by future cash flows, as well as the time horizon over which exchange rate changes affect prices and costs. The effective management requires familiarity with key foreign exchange market relationships, such as interest parity conditions and

purchasing power parity, which inform hedging and risk-mitigation strategies.

(2) *Managing Foreign Exchange Risk*: A bank shall establish open foreign exchange position limits, comprising both daylight limits and overnight limits. Daylight limits may be higher as exchange risk is easier to manage when the markets are open and the bank is actively dealing, and to accommodate client flows during business hours. Overnight position, being subject to greater uncertainty and risk, shall be set at a more conservative level. Having decided on the overall open position limits, the bank shall allocate these limits across their operating centres (if a bank holds positions at multiple centres). Within a centre, there could be a further allocation among individual dealers. A bank must ensure that systems are in place to monitor the overall open position limit for the bank on a real time basis.

(3) *Tools and Techniques for managing forex risk:* A bank may use various instruments such as forwards, futures, money-market positions, and options to hedge foreign exchange risk. Forwards are the most commonly used tool, though they entail counterparty default and replacement risk; exchange-traded futures may reduce default risk but introduce basis risk due to standardisation. Money-market borrowing, to invest in interest-bearing assets to offset a foreign currency payment, may serve as substitutes for forwards based on interest rate parity. Options may be used where exposures are non-linear, though their pricing and risk characteristics required specialised understanding.

D. Treasury Operations

39. The primary treasury activity of a bank is to cater to the customer requirements, in both the spot and forward market. This results in net foreign exchange positions that need to be managed on a real time basis. In the process of covering these positions, a bank may use spot–forward combinations that effectively create swap positions, which expose it to gap risk arising from changes in interest rates affecting the forward premia. Such gap risk shall be managed within Board-approved limits and monitored on an ongoing basis.

E. Risk Control Systems

40. The bank’s management should establish clear performance measurement criteria, accountability norms, and financial limits for treasury operations. Management must also clearly recognise the risks of trading arising from open

positions, credit exposures, and operations issues. A bank should put in place a system to independently evaluate mark to market values of the net positions taken, using objective market prices sourced from an external agency. All position limits should be explicit, simple, and easily enforceable.

Chapter-VI Repeal and Other provisions

41. With the issuance of this Guidance Note, the existing ‘Guidance Note on Management of Operational Risk’ as applicable to Regulated Entities stands repealed as communicated vide circular DOR.RRC.REC.302/33-01-010/2025-26 dated November 28, 2025.