Unit IV — Operational Risk Overview

Financial Credit and Risk Analysis | BMB FM 03 (also KMBN FM 05)

Unit IV: Operational Risk Overview

Syllabus: Risk and uncertainty; the financial sector; risk types. Operational risk management — recruitment and training, workflow design, workflow documentation, delegation of authority, independent internal audit, independent compliance function, independent risk management function, system audit, corporate governance, whistle blower policy, risk management culture.

Exam Blueprint (2023-24 and 2024-25 papers)

Topic	Years asked	Marks
Types of risk	2024-25	**10**
Operational risk vs other financial risks + ORM framework	2023-24	**10**
Risk vs Uncertainty	2023-24	2
Risk (define)	2024-25	2
Audit	2024-25	2
Role of independent internal audit, compliance and risk management	2023-24	2

YE QUESTION BAAR-BAAR AAYA HAI

Do 10-markers is unit se aaye hain — **types of risk** aur **operational risk versus other risks with the ORM framework**. Aur **risk vs uncertainty** ka 2-marker lagbhag pakka hai.

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1. Risk and Uncertainty

DEFINITION - RATTA MAARO

Risk is the **possibility of an outcome differing from what is expected**, where the **possible outcomes and their probabilities CAN be estimated** on the basis of past data or experience. Risk is therefore **measurable and quantifiable**.

DEFINITION - RATTA MAARO

Uncertainty is a situation where the **outcome cannot be predicted and the probabilities CANNOT be estimated**, because there is no past data or the situation is entirely new. Uncertainty is **not measurable**.

*(Frank Knight, in *Risk, Uncertainty and Profit* (1921), was the first to draw this distinction — worth citing.)*

1.1 Risk vs Uncertainty — the 2-mark comparison

Basis	Risk	Uncertainty
Meaning	Outcomes are **known**, and so are their **probabilities**	Outcomes and probabilities are **not known**
Measurability	**Measurable / quantifiable**	**NOT measurable**
Basis	**Past data**, experience, statistics	No past data; a novel situation
Probability	Can be **assigned**	**Cannot** be assigned
Insurability	**Insurable**	**Not insurable**
Management	Can be **managed, hedged, priced and provided for**	Can only be **anticipated and prepared for** broadly
Control	Largely controllable	Largely uncontrollable
Example	A bank estimating that 2% of its car loans will default, based on 10 years of data	The impact of a **completely new pandemic** or an unprecedented technological disruption

YAAD RAKHNE KA JUGAAD

Ek line me farak: **Risk matlab tumhe pata hai ki kya ho sakta hai aur kitni sambhavna hai. Uncertainty matlab tumhe ye bhi nahi pata ki kya ho sakta hai.** Risk ko naapa aur manage kiya jaa sakta hai. Uncertainty ko sirf jhela jaa sakta hai.

EXAM TIP - AISE LIKHO

Ek practical line likhna: *"Risk management converts uncertainty into risk. The whole discipline of risk management is an attempt to gather enough data and understanding to **move an exposure from the 'uncertainty' column into the 'risk' column**, where it can be measured, priced and controlled."*

1.2 Related Concepts

Peril — the actual cause of a loss (fire, theft, default). **Hazard** — a condition that increases the chance or severity of a loss (storing inflammable material, weak internal controls). **Exposure** — the extent to which one is subject to a risk. **Risk appetite** — the amount and type of risk an organisation is **willing to accept** in pursuit of its objectives. **Risk tolerance** — the acceptable variation around the appetite. **Risk capacity** — the maximum risk the organisation can **survive**.

2. Risk in the Financial Sector

2.1 Why Financial Institutions Are Special

Banks are uniquely exposed to risk because they are **highly leveraged** (a bank's capital is a small fraction of its assets, so a small loss in assets wipes out a large share of capital); they **transform maturity** (borrowing short through deposits and lending long); they **transform liquidity** and are exposed to **runs** based on confidence; and they are **interconnected**, so the failure of one bank can cascade into **systemic risk**. This is why banking is one of the most heavily regulated industries in the world.