



Institute  
and Faculty  
of Actuaries

## Operational Risk Modelling – Spuriouser and Spuriouser...

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20 March 2014

### Agenda

- This house believes operational risk modelling is spurious
- Value adding operational risk modelling
- How well do you understand your operational risk model?
- Common problems
- Hints and tips
- Conclusions



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## The debate

*“This house believes there is no point modelling operational risk capital - fundamentally it’s guesswork”*

Versus

*“Operational risk capital modelling should be a significant value add – deepening your understanding of risks and driving improved risk management behaviours”*



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## Actuaries in wonderland?



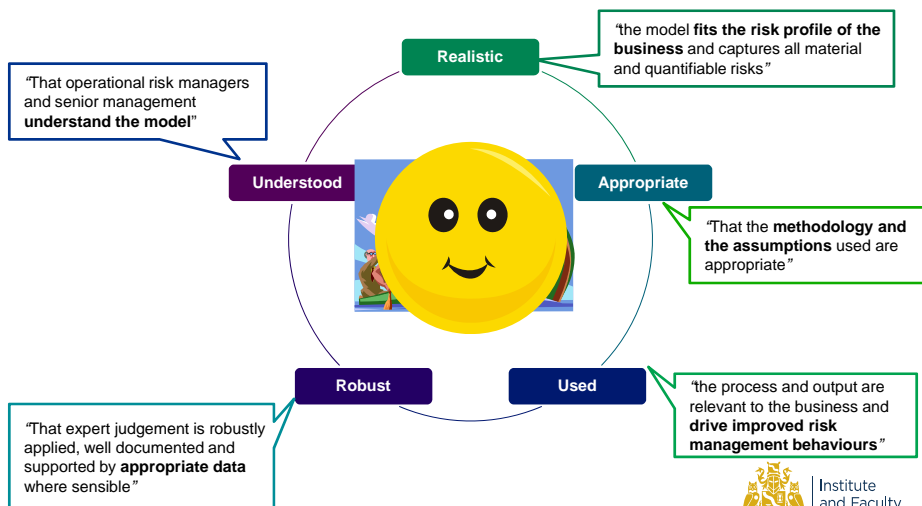
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## The call to action!



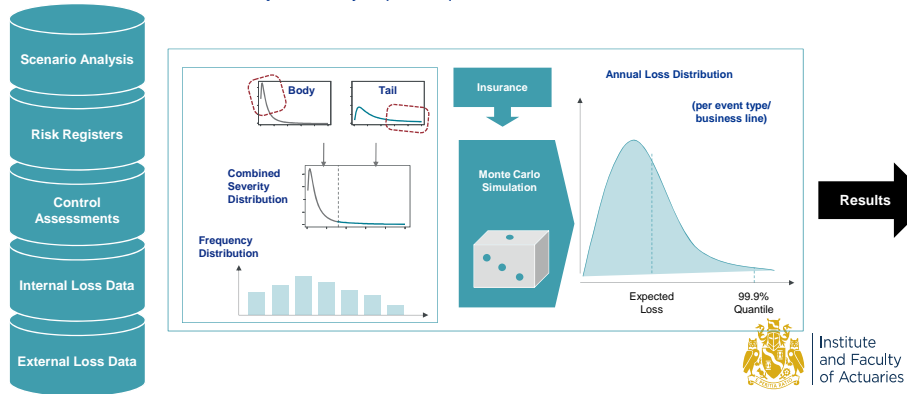
## Value adding operational risk modelling



## So what really drives capital?

### Questions:

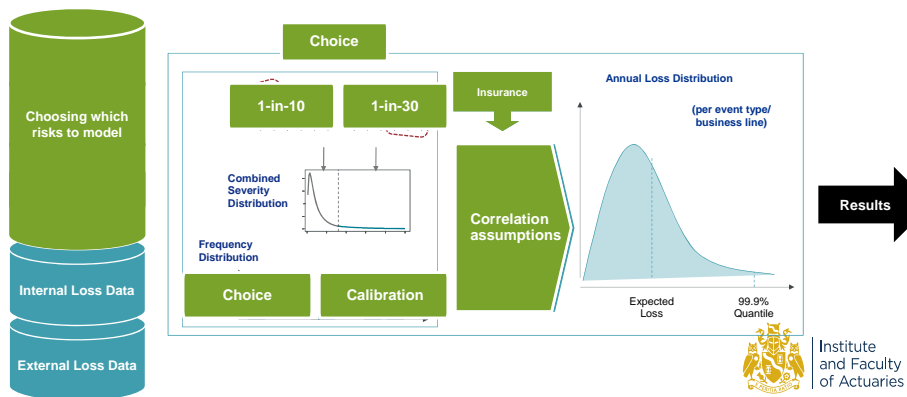
- What are the key **assumptions** and **judgements** involved?
- How **sensitive** is the model to these?
- What can I do to **optimise** my capital requirement?



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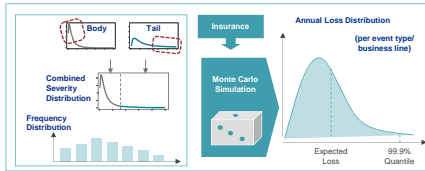
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## Thoughts on optimal solution

- ✓ Fits the risk profile of the business and captures all material and quantifiable risks



- ✓ Senior management **understand** the model and use the output of the model in the business

- ✓ Drives **improved risk management** behaviours

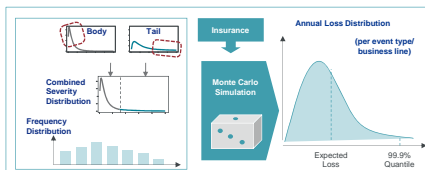
- ✓ Expert judgement is **robustly applied**, well documented and supported by data where possible.

- ✓ Methodology and the assumptions used are appropriate



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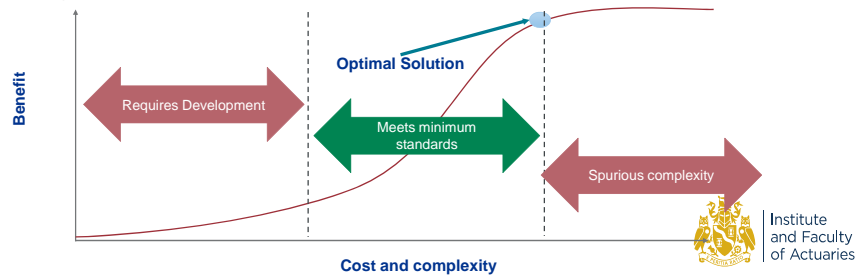


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## The view from Operational Risk

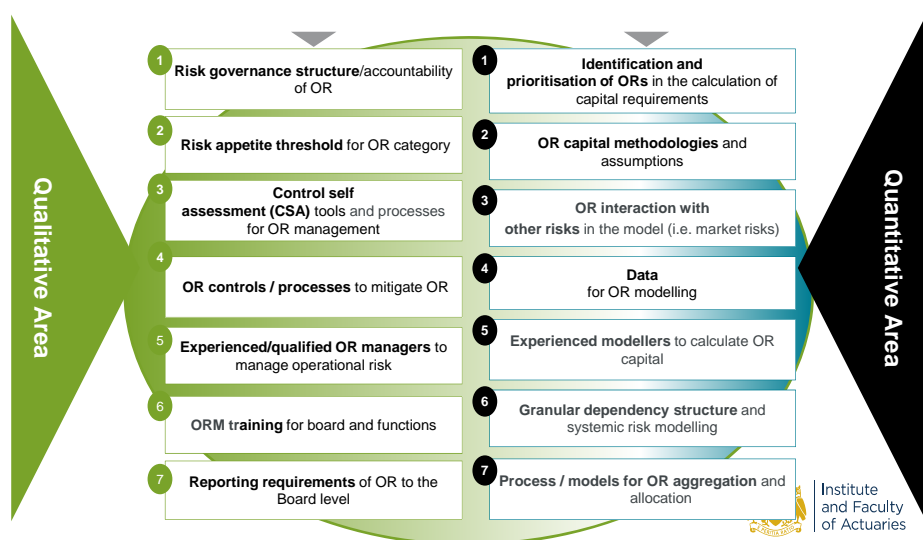
- Typically owned within the OR function...reluctantly.
- OR capital assessment is not an activity of comfort for many OR professionals.
- Frequency and depth of regulatory deep-dives increasing.
- Conduct Risks remain a component of the OR assessment and the risks, driven by the regulatory agenda are significant.
- Senior Management oversight and challenge of the activity is increasing.



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## Bringing it together



## Common problems

- Confusion about roles and responsibilities, worsened by isolation between teams
- Lack of data / poor use of the data that does exist (including external sources)
- Poor validation of expert judgement
- Correlation approach and diversification impacts
- ICG/Selling it to the regulator – why should they have confidence in the approach



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## Hints and tips

- OR capital assessments should clearly outline the role of each department to ensure maximum benefit, for example:
  - Actuarial attending scenario workshops
  - OR working with Actuarial during the modelling activity
  - The business owners involved at appropriate stages
- Use all available data to help justify the chosen parameters, using a pro-forma template to force particular data capture, in particular:
  - Risk and Control Assessment data
  - Internal and External event information (including data consortium, enforcement notices and media coverage)
- OR frameworks to be developed to align with modelling requirements and vice versa
  - e.g. Granularity of risk categorisation



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## Hints and tips

- Templates should be used to force capture of required data to support the selection of parameters, drives a consistent approach
- Correlations should be set using a structured process that involves business SMEs, OR teams and Actuarial
  - A workshop is an effective way to drive out the necessary information
  - Formal capture of the output is required, including rationale on the strength of relationships
- The methodology and approach to the OR capital assessment must pass the regulator scrutiny, assisted by:
  - A robust understanding throughout the business of the overarching methodology
  - Robust governance and oversight, supported by documentary evidence



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## Conclusions

*“This house believes the operational risk capital modelling process should be a significant value add – deepening your understanding of risks and driving improved risk management behaviours”*

**BUT**

*“Finding the optimal modelling solution is hard - striking the right balance between practicality and complexity to implement an effective process that will be acceptable to the regulator and value adding to the business”*



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**Questions**

**Comments**

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.

