



Operational Risk Modelling – what is the point?

A discussion at the Institute of Risk Management, 17th March 2010

Talking points to cover

- Op risk modelling:
 - Reasons for
 - Reasons against
- The difficulty in predicting operational risk
- How can Operational Risk be modelled
- Questions/ alternative views

Op risk modelling

Reasons for

- Most controllable – most commercially geared – a differentiator.
- Op risk is the ultimate Achilles heel and rating agents and regulators must eventually mandate strong op risk as a component in strongly assessed firms.
- Op risk analysis can be used to identify correlations between other risk classes.

Reasons against

- Not enough data to be credible
- Op risk is cause, ICML are defined by where they impact the balance sheet. Too late after centuries to recalculate past losses by cause.
- Not a big enough capital saving.
- Bigger areas to focus on first.

The difficulty in predicting operational risk

- Double counting
- Infuriatingly inconsistent – past performance is absolutely no guide to the future.
 - Survivor bias/ cycles of vigilance/ controls as a cost or an investment
 - Nowt as queer as folk
- Lack of credible data – subjective and political.

How can operational risk be modelled #1

- Need to understand how op risk fits with other risk classes and major risk impacts.
- Need to ensure that all major risks understood – at least the ones that have happened. Loss reporting/ near miss reporting, with forced reporting.
- Categorise risks into modelled elsewhere/ partially modelled elsewhere (emerging risk, benign experience)/ not modelled at all.
- Take loss experience and/ or extrapolated loss scenario based on real data (turnover as % applied to average cost of recruiting and average salary, overtime in interim, cost of training).
- Expected loss, foreseeable loss (1 in 4 maybe), extreme loss.
- Compare internal scenarios/ loss forecasting with external data where possible.

How can operational risk be modelled #2

- Consider including operational risks with no individual loss value but that influence multiple operational risks simultaneously (culture and lack of training, for instance).
- Create a correlation matrix for operational risks (0,25,50,75,100 % values).
- May like to set out which operational risks would have an impact on the net ULR and which would lead to expense overrun as allows prudent operational risk to be factored in to net ULR calculation.
- Stress and scenario testing starts to circle back for those risks based on scenarios so avoid temptation to take verifying calculations too seriously.
- Do not feel the need for perfection – all modelling is an approximation and needs to be seen in context.

Questions/ alternative views