Print | Close

Risk.net
Financial Risk Management News and Analysis

Consortiums look beyond historical loss data

Author: Victoria Tozer-Pennington

Source: Operational Risk & Regulation | 01 Aug 2010

Categories: Operational Risk, Measurement

Topics: American Bankers Association (ABA), Latin America, Argentina, India, Indian Banks' Association, Qualitative approach, Operational risk modelling, Operational risk capital, Mike Finlay, RiskBusiness, British Bankers' Association (BBA), Operational Riskdata eXchange Association (ORX), Data consortiums, Loss data

The financial crisis has shown historical loss data is not enough to help model and predict future op risk events, so some loss data consortiums are looking to include features such as scenario analysis results in their databases

Historical loss data is a prerequisite for any good operational risk management framework, but cannot predict the future. Having more and better historical loss data would not have helped firms predict the financial crisis. However, some suggest more detailed data might have helped banks be better prepared for the downturn.
"The financial crisis has been a salutary experience for risk managers, with the credibility of risk models and scenarios seemingly undermined because of their inability to predict critical liquidity constraints and insolvency implications," says David Dooks, statistics director at the British Bankers' Association (BBA). "But models are never going to be crystal balls – they are there to quantify the capital needed to withstand something like a one-in-1000-years event in the tail end of a loss distribution."

This emphasis on the nuts and bolts of operational risk management requires a greater assimilation of information, not just loss data, than ever

During the crisis models spectacularly failed to forecast how extreme the downturn would be, which has led many to question the value of using historical loss data as the main input to an op risk model. One of the major shortcomings of internal loss data consortiums is their focus on pared down statistical information for modelling inputs, with causal factors – why incidents occurred – often omitted from the cleansed data, primarily to protect the anonymity of the institution.

"One of the drawbacks with consortium data to date has been that the focus has been on statistical information around frequency and severity, which, while of some use for modelling purposes, provides no insight into why things happened and whether such events could possibly happen again," says Mike Finlay, chief executive and founder of RiskBusiness International.

This has led some loss data consortiums to look at expanding their data sets to include more detail around causes of losses and near misses, and in some cases scenarios are slated to be included.

"Increasingly, regional and local loss data consortiums are recognising this and are looking to augment their data collection in a number of ways: adding indicators and related metrics, adding more granular classification structures and anecdotal information relating to events, and looking to compare scenarios across participants," says Finlay.

The Operational Riskdata eXchange Association (ORX) has undertaken a scenario analysis study, which was intended to give the consortium a sense of where financial institutions are at with their scenario analysis frameworks, what they are being used for and their impact on op risk management. The study was enthusiastically received, says Simon Wills, executive director of ORX, with 45 of its members taking part – the largest ever response for one of its surveys.

"Part of the reason for the survey was so we could learn about the range of practice in scenario analysis and we learnt a great deal from it," says Wills. "We are now looking to document leading practices in a formal report that will be published before the end of the year. One of the problems banks have with scenario analysis is that it is difficult to validate results. For example, whether they are testing the right scenarios and whether the outcome is reasonable or not. Our members have supported the concept of a scenario exchange but our schedule is to document the leading practices first, which gives us the knowledge to be able to make the exchange work."

ORX is implementing more changes to its global database to add value for its members. "We are trying to do more but we are doing this for positive reasons, not in reaction to the crisis," says Wills. "We have succeeded in creating a great platform and a great database and we now want to build on that. We are trying to expand what we can do with the data that we collect; and we are trying to expand the services that we offer. In terms of the data itself, for our global database, as of November, we will be collecting product and process factors for all loss events. All our members are shifting to that, which we consider to be a major step forward."

The consortium already includes extended loss standards for large loss events. "Anything over €10 million is already coded for by business line, event type, product, process, causes and controls, as well as a variety of factors that might have influenced the severity of the loss such as the legal jurisdiction, what was the member's role in the transaction, what type of customer they were dealing with – was it during a period of economic volatility. We came to those factors from incidences such as the Bernie Madoff fraud. A bank could lose $10 million to $100 million depending on its engagement with the event: whether it was in the US or Europe, or acting on behalf of a client or alone."

The consortium is also proud of its scaling tool, which it is getting independently validated, and its work on quality assurance, which will be set out later in the year. ORX has also established national services in Canada and Spain, and is working on creating custody, insurance and fraud services. It also undertakes a capital benchmarking service every year, compiling capital numbers from each of its members' annual reports and producing a report that is distributed to its membership.

"We think about ORX as a platform: the membership, the system, the legal agreement, the data, the analytics and, importantly, the positive culture and co-operation among the members," says Wills. "Up until two years ago we were really doing just one thing with that platform – the global database service. That wasn't the greatest use of an expensive platform. Now we are thinking about how we can reuse that platform to give more value to members: national services, sector services, joint research and analytical tools."

While ORX is improving its offering to members, some banks use consortium data in conjunction with an external loss database such as Algorithmics' First service to give them extra causal factors relating to losses that are important in helping firms to mitigate potential loss events.

"We have seen an uptick in enquiries post-financial crisis," says John Winter, head of the operational risk team at Algorithmics. "There is an increasing interest in the causes of operational risk events. Boards of directors are asking where these events come from and what they can do about it. The level of detail from the First cases and the fact the underlying sources are quoted allows members to follow up on issues more themselves. Our clients tend to use both ORX and First because they like the detail in our case studies but need the large-scale data for modelling."

Op risk managers for the most part are paying more attention to the importance of managing operational risk rather than measuring it. They are looking at the factors behind loss events to help mitigate the possibility of them being repeated at their organisations.

"Given that in some cases models did not forecast recent extremes, it is reassuring to see risk managers and operational risk managers in particular now focusing on where they can make a real difference to their business – by establishing and monitoring process or product controls, and assessing the likelihood of losses arising from failed processes, systems, people or external events," says the BBA's Dooks. "Increasingly in the post-crisis world, operational risk managers are, quite rightly, asking why events occurred, what their institution might be faced with, when risk indicators are appropriate and how internal controls can be strengthened. This emphasis on the nuts and bolts of operational risk management requires a greater assimilation of information, not just loss data, than ever. Loss data consortiums will provide more pieces of the jigsaw as we go forward, simply because they will accumulate more event circumstances, more information for root cause analysis and more detail on processes than an operational risk manager sitting in a single institution will ever accumulate internally. The successful data consortiums will be those that address the micro-management needs of operational risk, offer wide institutional access and recognise capital modelling as an associated but separate discipline."

National databases
As more regions around the world look to implement Basel II and operational risk management frameworks, op risk loss databases are in demand. In recent months there has been a increase in the number of national loss database consortiums being set up.

In early July, the Indian Banks' Association (IBA) announced it is floating its new loss data consortium, the Credit Operational Risk Data Exchange (Cordex). Set up as a private limited company, Cordex is formed of 13 Indian banks, including the State Bank of India, ICICI Bank, Union Bank of India, Punjab National Bank, Bank of Baroda and Canara Bank. All will hold equity in the new company.
There is also a lot of work being done in Latin America to establish national and regional loss data consortiums.

"One of the problems that local banks have with larger providers is that it is often too expensive for them," says Alfredo Roisenzvit, chief executive of Acme Consultura in Argentina. "Also the usually high thresholds present in Europe or the US wipe out most of their losses due to exchange rates and volumes. Local databases would probably need to have almost no threshold, or $1,000, to be able to capture the whole picture. But it should not be solely aimed at small banks, it should be for all. Big banks have more incentive to be part of a consortium because they will provide and also get valuable information on the region, in addition to what they already have with the more globally active consortiums."

Thresholds in the largest data consortiums are a big problem for smaller banks, and some consortiums have lowered their thresholds in recent months.

"We have just lowered the threshold of our second data flow [DIPO_AI, a qualitative data flow with an extended description of all losses] from €1 million to €250,000 going back to January 1, 2007," says Claudia Pasquini, secretary-general of Dipo, the Italian operational risk data consortium. "Given the focus on scenario analysis after the crisis, our steering committee approved this change under the hypothesis that sometimes the description of events with low/medium loss amount can nonetheless be interesting when it comes to 'imagine what could also happen to us'."

Cost is the main reason cited by smaller firms, who need access to loss data but aren't able to justify the membership fees charged by larger consortiums. But in many cases membership to larger consortiums is denied to smaller banks because they cannot meet the stringent data standards and volumes required to join.
ORX vigorously defends its pricing structure. "We think that if you are going to do this [setting up a loss data consortium] you should do it properly, in terms of legal security, data security and quality assurance, none of which is cheap," says Wills. "Our members run our association and approve of our pricing. They demand the quality we deliver in terms of the data service, and value the other work and services we deliver."

Offering a cheaper, scaled-down service is not an option for ORX. "We have discussed an 'ORX Lite' service in the past but have not had an opportunity where it has been worthwhile to take a different approach," says Wills. "That doesn't mean we won't in the future, but there will be a boundary beyond which we won't be prepared to venture in terms of data security and data quality, to protect our reputation."
There is also an argument that national and regional consortiums are able to offer a more tailored service. One example is an attempt by Saudi banks to set up a consortium of local institutions that contains data relating to sharia-compliant products.

"Typically, local and regional consortiums are able to adapt their collection approaches more easily than a global consortium, as peer groups can more easily agree on changes and work together to address local issues," says Finlay. "Local and regional consortiums also reflect a more comprehensive perspective of the area they represent, implying more complete data, while facilitating peer group comparison and the benefit of learning from each other. The route to the future has to be an umbrella of such local and regional consortiums permitting the sharing of data between local and regional consortiums, thereby moving towards a more complete global picture."

ORX argues that start-up national consortiums could experience difficulties in compiling enough data. "We would like to work with national consortiums," says Wills. "Our experience is that setting up a loss consortium is not an easy thing to do and new initiatives can learn from our mistakes. We would hope this might mean using the infrastructure, systems and knowledge we already have in place. It's re-using the platform again. Starting from scratch leaves a long haul to value in terms of data sufficiency and a small group might even struggle in the longer term."

There are certainly obstacles to setting up a regional consortium, as the Asean loss data consortium discovered. A survey conducted in June 2007 to determine the appeal of a loss consortium among firms in the 10 member nations showed 19 out of the 27 banks who responded to the survey, from Malaysia, Burma, the Philippines, Singapore, Thailand and Vietnam, would consider joining an external loss data consortium. However, it became apparent late last year that banks in the Asean region were at varying stages of development in their op risk frameworks and systems, which has made the creation of a regional loss databases difficult. As a result the project has been shelved.

Other national or regional consortiums face several challenges in ensuring member participation. "One stone we need to remove from our path is a cultural problem," says Acme Consultura's Roisenzvit. "Banks are naturally opposed to sharing information, they somehow believe information will get into the hands of their competitors, which from a technical point of view is impossible. Moreover, IT managers believe information should not leave the physical premises of the bank, so are against initiatives such as software as a service. Even if the op risk manager wants to join the consortium, the IT department can veto them, and the general manager or board members usually lean in favour of the IT managers because they are fearful of competitors getting hold of their loss data. This is a very real problem we have. The final challenge is that nobody wants to become the first member."

Cultural problems are the most difficult to change. A fact that is understood clearly by the central bank in Argentina and which is what promoted it to take a mandatory approach. The banking regulator has created a mandatory risk loss data consortium, whereby banks have to submit a picture of their loss database quarterly, which it then aggregates and feeds back to the banks. "We have not seen any aggregated reports yet so it remains to be seen how well it will work. In theory it looks promising," says Roisenzvit.

However, there are also drawbacks to this method. “The problem with the mandatory approach is that, because banks have to do it, it is not in their interest to put all of the relevant information down as they would for ORX, for example. In this instance it is just a compliance exercise. It also contains public sector uncertainties that are often well-based in Latin American countries. The logic of broader consortiums is being able to integrate the whole region. Even if central banks provide this information, there will still be room for a private service to add value to that basic information.”

This attitude is shared by many in the national database space. “We have been saying for years that there is value in having both national and international consortiums,” says Jane Yao, vice-president, benchmarking and survey research at the American Bankers Association. “It is encouraging to see that concept being more widely appreciated.”

Regardless of how many consortiums are eventually set up, keeping an open dialogue between them is a desire shared by all.

“We are a small organisation and therefore it is entirely likely national databases are going to be set up,” says Wills. “I don’t think our position has changed over the past five years: if they are set up, it is much better if we talk to each other and learn from each other, and have a dialogue about making data standards comparable so we don’t close off some sort of exchange in the future.”

Print | Close