

TOWARDS A FRAMEWORK FOR OPERATIONAL RISK IN THE BANKING  
SECTOR

by

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## ABSTRACT

Towards a Framework for Operational Risk  
in the Banking Sector

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The purpose of this research is to provide clarity; based on theory and empirical evidence, on what the specific problems in the *operational risk* (OpRisk) literature are, given how its importance has increased significantly over the last decades. There have been a series of destructive events that have threatened the stability of the financial system due to (OpRisk). In most, if not all of these cases, human error is at the center of the chain of events that lead or may lead to (OpRisk) losses. There are many attitudes that can potentially infect organisational processes, the most persistent of these attitudes stem from human failings that are exploitable Barberis and Thaler (2003), thus forming a basis for the theoretical foundation of OpRisk.

Shefrin (2016) notes that people would rather incur greater risks to hold on to things they already have, than the risks they would taken to get into that position in the first place, thereby risking a banks' survival, rather than expose their trading losses by consciously deceiving senior management to hide unethical operational practices. In this paper the application of machine learning techniques on the ob-

served data demonstrates how these issues can be resolved given their flexibility to different types of empirical data.

(128 pages)

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## DEDICATION

This work—the dissertation and all work associated with it—is dedicated to .... I will always be grateful to her and for her. I also dedicate this work to my child, who patiently loved a father who was often busy working, even when at home. Finally, I dedicate this work to my parents and siblings, who kept me level-headed throughout the process, providing wise and thoughtful advice.

This work is truly evidence of the love I am surrounded by.

*Mphekeleli Hoohlo*

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# CHAPTER 1

## INTRODUCTION

### **Purpose of the study**

The purpose of this research is to apply a generalised linear model (GLM) suitable for exposure-based operational risk (EBOR) treatments within the operational risk management framework (ORMF), effectively replacing historical loss severity curves obtained from historical loss counts, by forward-looking measures using event frequencies based on actual operational risk (OpRisk) exposures. Preliminary work on EBOR models was undertaken by (Einemann, Fritscher, and Kalkbrener, 2018). Secondly, this study provides a comprehensive computational comparison of various data-intensive techniques amongst each other, and versus *classical* statistical estimation methods for classification and regression performances.

Our understanding of existing ORMF to date is limited to the assumption that financial institutions (FI's) are risk-neutral. Thirdly, in lieu of the aforementioned, this study finally seeks to invalidate the risk-neutral assumption, by means of various unsupervised learning techniques, by proposing that FI's are more risk-averse; this can be measured by analysing subtle patterns between data features and trends in the allocated risk capital estimates. In theory, a risk manager who experiences persistent/excessive losses due to particular risk events, would over-compensate cover for these particular risk types, and this would show in reduced losses in these types over time.

## The theoretical foundation of OpRisk

Most banks' estimates for their risk are divided into credit risk (50%), market risk (15%) and OpRisk (35%). Cruz (2002) postulated that OpRisk, which focuses on the human side of risk management is difficult to manage with the reduced ability to measure it. The process of OpRisk, that is, the how manifests in conscious and/or unconscious states of the risk manager/s (Hemrit and Arab, 2012), and encompasses approaches and theories that focus on how one will choose when faced with a decision, based on how comfortable they are with the situation and the variables that are present.

### *Definition of operational risk*

Operational risk (OpRisk) is defined as: *The risk of loss resulting from inadequate or failed internal processes, people and systems, and from external events. This definition includes legal risk, but excludes strategic and reputational risk.* (Risk, 2001).

A major managerial concern for businesses is an inability to identify and account for their susceptibility to OpRisk events following a number of very costly and highly publicized operational losses, in particular, it became popular following a fraudulent trading incident which was responsible for a catastrophic loss that led to the collapse of Barings Bank (the UK's oldest bank) in 1995.

The term OpRisk began to be used after the afore-mentioned and similar types of OpRisk events became more common. A (rogue) trader (Nick Leeson), who risked the banks' survival rather than expose his trading losses, by consciously deceiving senior management to hide his unethical acts, was found to have been responsible for unethical trading practices when he created illegal trades in his account, then used his position in the front and back offices of the bank to hide his trading losses. Worse still, he incurred a greater risk to the bank by lying in order

to give a false impression of his profits. Shefrin (2016) notes that people would rather incur greater risks to hold on to things they already have, than the risks they would taken to get into that position in the first place.

It was later discovered that he was placing illegal bets in the Asian-markets, and kept these contracts out of sight from senior management to cover up his illegal activity. When his fraudulent behaviour was discovered (after an earthquake hit at Kobe in Japan, that collapsed the Osaka Securities Exchange) he succumbed to unrecoverable losses due to trading positions he had accumulated, which resulted in a loss of around £1.3 billion to the bank, thus resulting in it's collapse. In most, if not all of these cases, human error is at the center of the chain of events that lead or may lead to OpRisk losses.

Since then, there have been a series of destructive events that have threatened the stability of the financial system due to OpRisk. Large fines have been imposed on the culprits and regulatory scrutiny has been heightened as a result of a number of operational events, e.g. the January 2016 "Dark Pool" trading penalties suffered by Barclays (\$70mn) and Credit Suisse (\$85mn), imposed by the United States (US) based securities exchange commission (SEC). These OpRisk loss events were due to fraudulent trading activity consisting of rogue traders dealing in illegally placed high frequency trades for private clients where prices were hidden.

In South Africa (SA), there is an upcoming case of price fixing and market allocation in trading foreign exchange (FX) currency pairs, reffered to the SA based competition tribunal for prosecution. Absa bank, Standard bank & Investec may be liable to payment of an admistrative penalty equal to 10% of their annual turnover in 2016, following accusations by the local based competition commission in February 2017, of rogue traders manipulating the price of the rand through buying and selling US dollars in exchange for the rand at fixed prices. According to the com-

petition commission, it has been alleged that currency traders have been colluding or manipulating the price of the rand through these buy and sell orders to change supply of the currency.

This has compromised the quality and accuracy of risk management's advisory service and pedigree, and aroused huge interest as the value of the rand has implications on South African's. Furthermore, this kind of behaviour can lead to catastrophic operational losses, as with the case for the Barings event, resulting is a mismatch between business' expectations and the value the risk management practice was able to deliver, which is prevalent across FI's and remains unchanged. There are many attitudes that can potentially infect organisational processes, the most persistent of these attitudes stem from human failings that are exploitable (Barberis and Thaler, 2003); i.e. humans' propensity to be deceitful during periods of distress, thus forming a basis for a theoretical foundation of OpRisk management.

### **Basel Committee's quantitative operational risk management framework**

The Bank for International Settlements (BIS) is an organisation consisting of a group of central bank governors and heads of supervision of central banks around the world who represent an authority on good risk management in banking. More specifically, the BIS oversee the duties of the Basel Committee on Banking Supervision (BCBS)/Basel Committee. The role of the BCBS is to set out guidelines on international financial regulation to cover risks in the banking sector. There have been three banking accords from the BCBS under the supervision of the BIS in dealing with financial regulation, viz., Basel I, Basel II & Basel III. These accords describe an overview of capital requirements for financial institutions (FI's) in order to create a level playing field, by making regulations uniform throughout the world.



*The Capital Adequacy Accord (Basel I)*

Basel I was established in 1988. Basel I meant that FI's were required to assign capital for credit risk to protect against credit default. In 1996, an amendment to Basel I imposed additional requirements to cover exposure due to market risk as well as credit risks. Basel I effectively minimised rules that favoured local FI's over potential foreign competitors, by opening up global competition so that these banks could buffer against international solvency. In 2001, the Risk (2001) consultative package provided an overview of the proposed framework for regulatory capital (RC) charge for OpRisk. A financial institution (FI) has an OpRisk component, which constitutes a substantial risk component other than credit and market risk. There are two types of OpRisk's viz., potential high severity risk where the probability of an extreme loss is very small but costly, and high frequency/low severity risk where frequency plays a major role in the OpRisk capital charge calculation.

*New Capital Adequacy Accord (Basel II)*

The framework for Basel II was implemented in June 2006. Basel II introduces more restrictive capital charge measures with specific emphasis on OpRisk. Under Basel II OpRisk loss events (i.e. a default in the credit risk jargon) are categorised under seven event types. e.g., Process Risk is one such category and is usually responsible for most OpRisk events, it is the risk that operational losses/problems would take place in the banks transactions.

Regarding the sequence Basel I and Basel II: Regulation begins as a qualitative recommendation which requires banks to have an assets-to-capital multiple of at least 20, then focuses on ratios in which both on-balance sheet and off-balance sheet items are used to calculate the bank's total risk-weighted assets (RWA's)<sup>1</sup>,

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<sup>1</sup>Also referred to as risk-weighted amount, it is a measure of the bank's total credit exposure

then on tail risk. In other words, auditors' discretion is replaced by market perception of capital, meaning there is a market risk capital charge for all items in the trading business line, then exciting new static risk management approaches which involve calculating a 99.9 percentile left tail confidence interval to measure OpRisk value-at-risk (VaR) and convert it into a RC charge.

### *Basel III*

Basel III establishes tougher capital standards through more restrictive capital definitions, higher RWA's, additional capital buffers, and higher requirements for minimum capital ratios (Dorval, 2013). Through Basel III, the BCBS is introducing a number of fundamental reforms grouped under three main headings (Committee and others, 2010): 1] A future of more capital through incremental trading book risk (credit items in trading book treated in the same way as if they were in banking book), 2] More liquidity through the introduction of a global liquidity risk standard (Basel III will push banks toward holding greater levels of liquid instruments, such as government bonds and more liquid corporate instruments), and 3] Lower risk under the new requirements of the capital base, i.e., establish more standardized risk-adjusted capital requirements.

The future regulatory environment requires OpRisk professionals, who are not only intelligent, creative and motivated but also have the courage to uphold the OpRisk advisory service standards. Businesses that want to successfully manage risk, would be well advised to utilize new theoretical and empirical techniques, such that large and small scale experiments play an important role in risk analysis and regulatory research.

## modern OpRisk measurement frameworks (ORMF's)

Basel II describes three methods of calculating capital charge for OpRisk RC viz., the standardised approach (SA), the basic indicator approach (BIA) and the internal measurement approach (IMA). The basic indicator approach (BIA) sets the OpRisk RC equal to a percentage (15%) of the annual gross income of the firm as a whole to determine the annual capital charge. The SA is similar to the BIA except the firm is split into eight business lines and assigned a different percentage of a three year average gross income per business line, the summation of which is the capital charge (Hoohlo, 2015). In the IMA, the bank uses it's own internal models to calculate OpRisk loss.

### *Advanced Measurement Approach (AMA)*

The advanced measurement approach (AMA) is an IMA method which applies estimation techniques of OpRisk capital charge derived from a bank's internal risk measurement system Cruz (2002). Basel II proposed measurement of OpRisk to define capital requirements against unexpected bank losses whereas the unexpected loss (UL) is the quantile for the level  $\alpha$  minus the mean. According to the AMA, which is thought to outperform the simpler SA approach and the BIA, RC requirements are defined according to the UL limit in one year and the loss distribution at a 99.9% confidence level ( $\alpha = 0.01\%$ ) aggregate loss distribution<sup>2</sup> used as a measure of RC. The BCBS proposes to define RC as  $RC = UL$ . This involves simulations based on historical data to establish frequency and severity distributions for losses. In this case the RC is a VaR measure.

The Basel III capital adequacy rules permit model-based calculation methods for capital, including the AMA for OpRisk capital. Under Basel III, standardised

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<sup>2</sup>The aggregate loss distribution is obtained by convoluting a loss event frequency distribution and a loss severity distribution by means of the random sums method.

methods for OpRisk capital have been overhauled, however for a while there was no prospect of an overhaul of the AMA. Given the relative infancy of the field of OpRisk measurement, banks are mostly free to choose among various AMA principle-based frameworks to a significant degree of flexibility (Risk, 2016). A bank that undertakes an AMA should be able to influence their capital requirements through modeling techniques resulting in lowered pressure on OpRisk capital levels, which in turn has a positive impact on the bank.

A FI's ability to determine the framework used for its regulatory OpRisk RC calculation, evolves from how advanced the FI is along the spectrum of available approaches used to determine capital charge (Risk, 2001). BCBS recognizes that a variety of potentially credible approaches to quantify OpRisk are currently being developed by the industry, and that these R&D activities should be incentivised. Increasing levels of sophistication of OpRisk measurement methodologies should generally be rewarded with a reduction in the regulatory OpRisk capital requirement.

#### *The standardised measurement approach (SMA)*

The flexibility of internal models was expected to narrow over time as more accurate OpRisk measurement was obtained and stable measures of RC were reached, ultimately leading to the emergence of best practice. Instead, internal models produced wildly differing results of OpRisk RC capital from bank to bank, contrary to the expectations of the BCBS. In March 2016, the BCBS published for consultation a standardised measurement approach (SMA) for OpRisk RC; that proposes to abandon the freedom of internal modelling (thus ending the AMA) approaches for OpRisk RC, in exchange for being able to use a simple formula to facilitate comparability across the industry.

Under the SMA, RC will be determined using a simple method comprising of

two components: A stylised systemic risk model (business indicator component), and an idiosyncratic risk model (loss component), which are combined via an internal loss multiplier (ILM), whose function is to link capital to a FI's operational loss experience to determine SMA capital.

The SMA formula is thought to be consistent with regulators' intent for simplification and increased comparability across most banks. However, there is a feeling from some in the banking industry that the SMA is disadvantaged as it is not the same as measuring OpRisk. Mignola, Ugoccioni, and Cope (2016) and Peters, Shevchenko, Hassani, and Chapelle (2016) identified that the SMA does not respond appropriately to changes in the risk profile of a bank i.e., it is unstable viz., two banks of the same risk profile and size can exhibit OpRisk RC differences exceeding 100%, and risk insensitive; that SMA capital results generally appear to be more variable across banks than AMA results, where banks had the option of fitting the loss data to statistical distributions.

### *Argument*

Over the last twenty years, hard-won incremental steps to develop a measure for the size of OpRisk exposure along with the emergence of promising technologies presents a unique opportunity for bankers and treasurers - traditionally risk-averse players - to develop a novel type of way of looking at decision making under risk/uncertainty. New technologies have been introduced which make use of up to date technical solutions (such as homo heuristics developed by Gigerenzer and Brighton (2009), who maintain their methods solve practical finance problems by simple rules of thumb, or Kahneman (2003)'s intuitive judgements and deliberate decision making), argued to more likely represent the true embedded OpRisk in financial organisations as these methods are designed to fit normal behavioral patterns in their formulation, which is consistent with how decisions are made under

risk/uncertainty.

What are the important steps toward completing the post crisis reforms during the current year? Should the risk management fraternity follow the chartered<sup>3</sup> path followed in the Risk (2016) consultative document, scrapping away twenty years of internal measurement approaches (such as the AMA), or should the focus of financial regulators shift toward improving on what they see fit within current existing AMA frameworks. The question is should OpRisk managements' focus be on stimulating active discussions on practical approaches to quantify, model and manage OpRisk for better risk management and improved controls, or abandon the adoption of innovative measurement approaches, such as the AMA, in exchange for being able to use a simple formula across the whole industry?

### **Context of the study**

Regulatory reforms are designed and fines imposed to protect against operational errors and other conduct costs connected with wrongdoing and employee misconduct. Despite the introduction and use of these seemingly robust strategies, regulations, processes and practices relating to managing risk in FI's, bank losses continue to occur at a rather distressing frequency. A cyclical pattern of OpRisk loss events still persists; as evidenced in the recent price fixing and collusion cases, defeating the explicit objectives of risk management frameworks. This demonstrates a scourge of reflexivity prevailing in financial markets emphasising that, there are theories that seem to work for a time only to outlive their use and become insufficient for the complexities that arise in reality.

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<sup>3</sup>Meaning as of the publication [at risk2016supporting] the methods brought forth in the consultative document have not been approved for the public, the ideas within an experimental (leased) phase for the exclusive use of BCBS and certain FI's

*Why OpRisk?*

A forceful narrative in management theory is that an organisation running effective maintenance procedures combined with optimal team and individual performers i.e., the right balance of skills in the labour force and adequate technological advancements, means systems and services can be used to more efficiently produce material gains, enhance organisational effectiveness, meet business objectives and increase investment activity. Conversely, the risk of the loss of business certainty associated with lowered organisational competitiveness and inadequate systems technology that underpins operations and services is a key source leading to a potential breakdown in investment services activity (Hoohlo, 2015). In fact OpRisk control could set banks apart in competition. This serves as an incentive to support regulation, particularly Basel III recovery and resolution processes.

Consider the case of a regulator in a financial system, who assumes that he/she is consciously and accurately analysing an observed subject, trusting the validity and relying on the visual information that their sense of sight reveals. In the absence of visual confirmation they are hindered from extracting and/or analysing information about the system and their efforts to regulate could potentially fail. The organisational methods and functioning of current information systems in this industry sector obscure the full extent of OpRisk challenges from the eyes of the risk practitioner.

When an attack such as an operational error occurs at a speed that the OpRisk agent (an individual legal entity or a group) is unable to react quickly enough, due to limitations of their processing speed, and they are not able to process all the information in the given time span, they could lose control/fail to comply with regulatory standards. The latter case is more often than not the most accurate reflection of current risk management practices. The agent represents

one end of the spectrum of a risk management strategy, which mitigates risk and enforces regulation, dependent on the information recieved. The other end of the spectrum is one which does not react at all to changes in the system environment.

Current conventional financial systems where information processing is slow and have a tendency to rely on manual, uncertain, unpredictable and unrealistic controls, obscure risk management reporting and produce undesirable market conditions. The OpRisk management function should be able to assist the firms' ability to mitigate risks by acquiring and/or refining risk management solutions which deliver reliable and consistent benefits of improved control and management of the risks inherent in banking operations (Dorval, 2013). This proposal attempts to fill the gap in the current system where there is a risk management information lag or an obstruction from the eyes of the risk practitioner.

### **Analysis and interpretation issues with behavioral finance theory**

Behavioral management theory is very much concerned with social factors such as motivation, support and employee relations. A critical component of behavioral finance is building models which better reflect actual behavior. Studies have revealed that these social factors are not easy to incorporate into finance models or to understand in the traditional framework.

The traditional finance paradigm seeks to understand financial markets using models in which agents are "rational". According to Barberis and Thaler (2003), this means that agents update their beliefs on the onset of new information, and that given their beliefs, they make choices that are normatively acceptable, and that most people do this most of the time. Neoclassical theory has grown to become the primary take on modern-day economics formed to solve problems for decision making under uncertainty/risk. Expected Utility Theory (EUT) has domi-



nated the analysis and has been generally accepted as the normative model of rational choice, and widely applied as a descriptive model of economic choice (Kahneman and Tversky, 2013).

### *Expected utility theory*

Expected utility theory<sup>4</sup> (EUT): We see a fundamental relation for expected utility (Expectation) of a contract  $X$ , that yields outcome  $x_i$  with probability  $p_i$ , where  $X = (x_1, p_1; \dots; x_n, p_n)$  and  $p_1 + p_2 + \dots + p_n = 1$  given by:

$$U(x_1, p_1; \dots; x_n, p_n) = p_1 u(x_1) + \dots + p_n u(x_n) \quad (1.1)$$

corroborated by Morgenstern and Von Neumann (1953); Friedman and Savage (1948); Kahneman and Tversky (2013) & others.

A common thread running through the rational viz., the neoclassical take of modern-day economics vs the non-neoclassical schools of thought are findings of behavioral economics which tend to refute the notion that individuals behave rationally. Many argue that individuals are fundamentally irrational because they do not behave rationally giving rise to a literature and debates as to which heuristics and sociological and institutional priors are rational (Altman, 2008).

In the real world there is a point of transition between the traditional (neoclassical) approach to decision making, based on data and data analysis (logic and rational), by adding new parameters and arguments that are outside rational conventional thinking but are also valid. For example, that neoclassical theory makes use of the assumption that all parties will behave rationally overlooks the fact that human nature is vulnerable to other forces, which causes people to make irrational choices.

An essential ingredient of any model trying to understand trading behavior

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<sup>4</sup>Expected utility theory provides a model of rationality based on choice.

is an assumption about investor preferences (Barberis and Thaler, 2003), or how investors evaluate risky gambles. Investors systematically deviate from rationality when making financial decisions, yet as acknowledged by Kuhnen and Knutson (2005), the mechanisms responsible for these deviations have not been fully identified. Some errors in judgement suggest distinct mental operations promote different types of financial choices that may lead to investing mistakes. Deviations from the optimal investment strategy of a rational risk neutral agent are viewed as risk-seeking mistakes and risk-aversion mistakes (Kuhnen and Knutson, 2005).

*Theoretical investigations for the quantification of modern ORMF*

Kuhnen and Knutson (2005) explain that these risk-seeking choices (such as gambling at a casino) and risk-averse choices (such as buying insurance) may be driven by distinct neural<sup>5</sup> phenomena, which when activated can lead to a shift in risk preferences. Kuhnen and Knutson (2005) found that certain areas of the brain precede risk-seeking mistakes or risky choices and other areas precede risk-aversion mistakes or riskless choices. A risk-aversion mistake is one where a gamble on a prospect of a gain is taken by a risk-averse agent in the face of the chance of a prospective loss. The fear of losing prohibits one's urge to gamble, but people engage in gambling activity anyway. Barberis and Thaler (2003) show that people regularly deviate from the traditional finance paradigm evidenced by the extensive experimental results compiled by cognitive psychologists on how people make decisions given their beliefs.

Kahneman and Tversky (2013) maintains, preferences between prospects which violate rational behaviour demonstrate that outcomes which are obtained with certainty are overweighted relative to uncertain outcomes. This will contribute

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<sup>5</sup>As recent evidence from human brain imaging has shown [Kuhnen2005neural] linking neural states to risk-related behaviours [Paulus2003increased].

to a risk-averse preference for a sure gain over a larger gain that is merely probable or a risk-seeking preference for a loss that is merely probable over a smaller loss that it certain. As a psychological principle, overweighting of certainty favours risk-aversion in the domain of gains and risk-seeking in the domain of losses.

The present discussion replicates the common behavioral pattern of risk aversion, where people weigh losses more than equivalent gains. Furthermore, neuroeconomic research shows that this pattern of behavior is directly tied to the brain's greater sensitivity to potential losses than gains (Tom, Fox, Trepel, and Poldrack, 2007). This provides a target for investigating a more comprehensive theory of individual decision-making rather than the rational actor model and thus yield new insights relevant to economic theory<sup>6</sup> (Kuhnen and Knutson, 2005).

If people are reasonably accurate in predicting their choices, the presence of systematic violations of risk neutral behavior provides presumptive evidence against this i.e., people systematically violate EUT when choosing among risky gambles. This seeks to improve and adapt to reality and advance different interpretations of economic behaviour; viz., to propose a more adequately descriptive model, that can represent the basis for an alternative to the way the traditional model is built for decisions taken under uncertainty. This has led some influential commentators to call for an entirely new economic paradigm to displace conventional neoclassical theory with a psychologically more realistic preference specification (List, 2004).

## **A new class of ORMF models approach**

A substantial body of evidence shows that decision makers systematically violate EUT when choosing between risky prospects. Indeed, people would rather

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<sup>6</sup>Representing ability of FI's financial market models to characterise the repeated decision-making process that applies to loss aversion

satisfy their needs than maximise their utility, contravening the normative model of rational choice (i.e., EUT) which has dominated the analysis of decision making under risk. In recent work (Barberis and Thaler, 2003) in behavioral finance, it has been argued that some of the lessons learnt from violations of EUT are central to understanding a number of financial phenomena. In response to this, there has been several theories put forward advocating for the basis of a slightly different interpretation which describes how individuals actually make decisions under uncertainty/risk. Of all the non-EUT's, we focus on Prospect Theory (PT) as this framework has had most success matching most empirical facts<sup>7</sup>.

Kahneman and Tversky (2013) list the key elements of PT, which are 1] a value function, and 2] a non-linear transformation of the probability scale, that factors in risk aversion of the participants. According to Kahneman and Tversky (2013), the probability scale overweights small probabilities and underweights high probabilities. This feature is known as loss/risk aversion: This means that people have a greater sensitivity to losses (around 2.5 times more times) than gains, and are especially sensitive to small losses unless accompanied by small gains<sup>8</sup>. Loss aversion is a strong differentiator when it comes to explaining exceptions to the general risk patterns that characterize prospect theory.

### *Prospect theory*

By relaxation of the expectation principle in equation ??, the over-all value  $V$  of the regular prospect  $(x, p; y, q)$ : In such a prospect, one receives  $x$  with probability  $p$ ,  $y$  with probability  $q$ , and nothing with probability  $1 - p - q$ , is expressed in terms of two scales,  $\pi(\cdot)$ , and  $\nu(\cdot)$ , where  $\pi(\cdot)$  is a decision weight and  $\nu(\cdot)$  a num-

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<sup>7</sup>OpRisk loss events in FI's are largely due to human failings that are exploitable e.g., fraudulent trading activity, and PT is based on the same behavioural element of how people make financial decisions about prospects

<sup>8</sup>Diminishing marginal utility for gains but opposite for losses.

ber reflecting the subjective value of the outcome. Then  $V$  is assigned the value:

$$V = \pi(p)\nu(x) + \pi(q)\nu(y) \quad \text{iff} \quad p + q \leq 1 \quad (1.2)$$

The scale,  $\pi$ , associates with each probability  $p$  a decision weight which reflects the impact of  $p$  on the over-all value of the prospect. The second scale,  $\nu$ , assigns to each outcome  $x$  a number  $\nu(x)$ , which measures the value of deviations from a reference point i.e., gains or losses.  $\pi$  is not a probability measure and  $\pi(p) + \pi(1 - p) < 1$ . Through PT we add new parameters and arguments to improve the mathematical modelling method for decisions taken under risk/uncertainty, such that the value of each outcome is multiplied by a decision weight, not by an additive probability.

PT looks for common attitudes in people (in FI's) with regard to their behaviour toward taking financial risks or gambles that cannot be captured by EUT. In light of this view, people are not fully invested in either of the perceived outcomes  $x$  and  $y$ , Which tells us that  $p + q \leq 1$ . In lieu of this, an FI using (internal) historical OpRisk loss data to model future events; say a historical case of fraud at the FI occurs and is incorporated in the model, the probability of making the same error in future is provided for in the model versus risk events that haven't happened. The modelled future should over-provide for the loss events that have already occurred, which fits normal patterns around individuals psychological make up and is consistent with risk-averse behavior. The idea at the basis of PT is that a better modeling method can be obtained which leads to a closer approximation of the over-all-value of OpRisk losses.

### *Modeling*

In this study, an important new algorithm for ORMFs and is laid out coupled with data intensive estimation techniques; viz. Generalised Additive Models for lo-

catin Scale & Shape (GAMLSS), Generalized Linear Models (GLDs), Artificial Neural Networks (ANNs), Random Forest (RF) & Decision Trees (DTs), which have capabilities to tease out the deep hierarchies in the features of covariates irrespective of the challenges associated with the non-linear or multi-dimensional nature of the underlying problem, at the same time supporting the call from industry for a new class of EBOR models that capture forward-looking aspects. Machine Learning (ML) is used as a substitute tool for the traditional model based Autoregressive Moving Average (ARMA) used for analysing and representing stochastic processes. As opposed to the statistical tool, ML does not impose a functional relationship between variables, the functional relationship is determined by extracting the pattern of the training set and by learning from the data observed.

Using computationally intensive (using ML techniques on historical data ) OpRisk measurement techniques and mixing with a theory is not a new approach for modeling, particularly in calculating OpRisk RC; as evidenced through Agostini, Talamo, and Vecchione (2010) in a study whereby the LDA model for forecasting OpRisk RC, via VaR, was implemented in conjunction with the use of advanced credibility theory (CT). The idea at the basis of their use of CT, is to advance the very recent literature that a better estimation of the OpRisk RC measurement can be obtained by integrating historical data and scenario analysis i.e., combining the historical simulations with scenario assessments through formulas that are weighted averages of the historical data entries and scenario assessments, advocating for the combined use of both experiences.

However, applying ML is an original way of looking at the approximation issue as opposed to advanced CT. The essential feature of PT are assumptions which are more compatible with basic principles of perception and judgement for decisions taken under uncertainty, whereas ML will reveal additional chance probabilities determined through the natural clusters of unknown data feature findings from which

new discoveries are made.

According to Kahneman and Tversky (2013), the decision maker, who is a risk agent within the FI, constructs a representation of the losses and outcomes that are relevant to the decision, then assesses the value of each prospect and chooses according to the losses (changes in wealth), not the overall financial state of the FI. We wish to bring the prescribed model to equilibrium, by applying a method that tries to establish what accurately ascribes to decision rules that people wish to obey, in made predictions about what operational loss events might result in the future, then use empirical data to test this idea in a way that is falsifiable.

## **Problem statement**

### *Main problem*

The existing models of OpRisk VaR measurement frameworks assume FI's are risk neutral, and do not learn from past losses/mistakes: We address weaknesses in current OpRisk VaR measurement frameworks by assuming that FI's are more risk averse. Furthermore, introducing exposure-based operational risk modeling, we gain an understanding of how capturing past losses and exposures of forward looking aspects affect risk attitudes using machine learning techniques. As a consequence, projected future losses are estimated through a learning algorithm adapting capital estimates to changes in the risk profile, i.e. in the introduction of new products or changes in the business mix of the portfolio (e.g. mergers, trade terminations, allocations or disinvestments), providing sufficient incentives for OpRisk management to mitigate risk.

## Objectives of the study

The research objectives are three-fold:

### *Exposure-based OpRisk (EBOR) models*

To quantify OpRisk losses by introducing generalised additive models for location, scale and shape (GAMLSS) in the framework for OpRisk management, that captures exposures to forward-looking aspects of the OpRisk loss prediction problem. EBOR treatments effectively replace historical loss severity curves obtained from historical loss counts, by looking into deep hierarchies in the features of covariates in investment banking (IB), and by forward-looking measures using event frequencies based on actual operational risk (OpRisk) exposures in the business environment and internal control risk factors (BEICF) thereof.

### *Modeling OpRisk depending on covariates*

To investigate the performance of several supervised learning classes of data-intensive methodologies for the improved assessment of OpRisk against current *traditional* statistical estimation techniques. Three different machine learning techniques viz., DTs, RFs, and ANNs, are employed to approximate weights of input features (the risk factors) of the model. A comprehensive list of user defined input variables with associated root causes contribute to the *frequency* of OpRisk events of the underlying value-adding processes. Moreover, the *severity* of OpRisk is also borne out through loss impacts in the dataset . As a consequence of theses new methodologies, capital estimates should be able to adapt to changes in the risk profile of the bank, i.e. upon the addition of new products or varying the business mix of the bank providing sufficient incentives for ORMF to mitigate risk (Einemann et al., 2018).



### *Interpretation Issues using cluster analysis*

To identify potential flaws in the mathematical framework for the loss distribution approach (LDA) model of ORM, which is based the derivation of OpRisk losses based on a risk-neutral measure  $\mathbb{Q}$ , by employing Cluster Analysis (CA). The study addresses weaknesses in the current *traditional* LDA model framework, by assuming managerial risk-taking attitudes are more risk averse. More precisely, CA learns the deep hierarchies of input features<sup>9</sup> that constitute OpRisk event *frequencies & severities* of losses during banking operations. In theory, a risk manager who experiences persistent/excessive losses due to particular risk events, would over-compensate cover for these particular risk types. This would show in reduced losses in those loss event types over time, subsequently determining whether risk adverse techniques over-compensate for persistent losses.

### **Significance of the study**

This study fills a gap in that advancing OpRisk VaR measurement methods beyond simplistic and traditional techniques, new data-intensive techniques offer an important tool for ORMFs and at the same time supporting the call from industry for a new class of EBOR models that capture forward-looking aspects of ORM (Embrechts, Mizgier, and Chen, 2018). The current *traditional* approach consists of a loss data collection exercise (LDCE) which suffers from inadequate technologies at times relying on spreadsheets and manual controls to pull numbers together, and therefore do not support the use of data intensive techniques for the management of financial risks. In this study, a new dataset with unique feature characteristics is developed using an automated LDCE, as defined by Committee and others (2011)

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<sup>9</sup>A typical approach taken in the literature is to use an unsupervised learning algorithm to train a model of the unlabeled data and then use the results to extract interesting features from the data [coates2012learning]

for internal data. The dataset in question is at the level of individual loss events, it is fundamental as part of the study to know when they happened, and be able to identify the root causes of losses arising from which OpRisk loss events.

This study will provide guidance on combining various supervised learning techniques with extreme value theory (EVT) fitting, which is very much based on the Dynamic EVT-POT model developed by Chavez-Demoulin, Embrechts, and Hofert (2016). This can only happen due to an abundance of larger and better quality datasets and which also benefits the loss distribution approach (LDA) and other areas of OpRisk modeling. In Chavez-Demoulin et al. (2016), they consider dynamic models based on covariates and in particular concentrate on the influence of internal root causes that prove to be useful from the proposed methodology. Moreover, EBOR models are important due to wide applicability beyond capital calculation and the potential to evolve into an important tool for auditing process and early detection of potential losses, culminating in structural and operational changes in the FI, hence releasing human capital to focus on dilemmas that require human judgement.

## **Organisation of the study**

This study is made up of seven chapters. The introductory chapter is to the purpose, overview, research problem & objectives, and the significance of the study. The introductory chapter is succeeded by a general literaty review chapter (two) followed by three stand alone chapters each focusing on the three research objectives regarding the issues in OpRisk capital requirement estimation.

Chapter one begins with an account of significance and a commentary on the nature and scope of the practical problem. It then provides a background of current issues when dealing with OpRisk measurement, the research problem and research

questions thereof. Chapter two gives an overview of the literature concerning the LDA, an AMA technique used in the generation of OpVaR. It concludes by proposing the a research methodology in which a combination of ML techniques and statistical theory underlying ORMF's would benefit measurement of capital requirements for OpVaR.

Chapter three looks at the methodological and empirical determinants of OpRisk measurement. It explores the different dataset

## CHAPTER 2

### LITERATURE REVIEW

#### Introduction

A look into literary sources for OpRisk indicates (Acharyya, 2012) that there is insufficient academic literature that looks to characterize its theoretical roots, as it is a relatively new discipline, choosing instead to focus on proposing a solution to the quantification of OpRisk. This chapter seeks to provide an overview of some of the antecedents of OpRisk measurement and management in the banking industry. As such, this chapter provides a discussion on why OpRisk is not trivial to quantify and attempts to understand its properties in the context of risk aversion with the thinking of practitioners and academics in this field.

According to Cruz (2002), FI's wish to measure the impact of operational events upon profit and loss (P&L), these events depict the idea of explaining the *volatility of earnings* due to OpRisk data points which are directly observed and recorded. By seeking to incorporate data intensive statistical approaches to help understand the data, the framework analyses response variables that are decidedly non-normal (including categorical outcomes and discrete counts) which can shed further light on the understanding of firm-level OpRisk RC. Lastly, a synopsis of gaps in the literature is presented.

## The theoretical foundation of OpRisk

Hemrit and Arab (2012) argue that common and systematic operational errors in hypothetical situations poses presumptive evidence that OpRisk events, assuming that the subjects have no reason to disguise their preferences, are created sub-consciously. This study purports, supported by experimental evidence, behavioural finance theories should take some of this behaviour into account in trying to explain, in the context of a model, how investors maximise a specific utility/value function.

Furthermore its argued by integrating OpRisk management into behavioral finance theory,<sup>1</sup>, that it may be possible to improve our understanding of firm level RC by refining the resulting OpRisk models to account for these behavioral traits - implying that people's economic preferences described in the model, have an economic incentive to improve the OpRisk RC measure.

Wiseman and Catanach Jr (1997) suggest that managerial risk-taking attitudes are influenced by the decision (performance) context in which they are taken. In essence, managerial risk-taking attitude is considered as a proxy for measuring OpRisk (Acharyya, 2012). In so doing, Wiseman and Catanach Jr (1997) investigate more comprehensive economic theories, viz. prospect theory and the behavioural theory of the firm, that prove relevant to complex organizations who present a more fitting measure for OpRisk.

In a theoretical paper, Wiseman and Catanach Jr (1997) discussed several organizational and behavioural theories, such as PT, which influence managerial risk-taking attitudes. Their findings demonstrate that behavioural views, such as PT and the behavioural theory of the firm explain risk seeking and risk averse behaviour in the context of OpRisk even after agency based influences are controlled

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<sup>1</sup>In behavioral finance, we investigate whether certain financial phenomena are the result of less than fully rational thinking [barberis2003survey]

for. Furthermore, they challenge arguments that behavioral influences are masking underlying root causes due to agency effects. Instead they argue for mixing behavioral models with agency based views to obtain more complete explanations of risk preferences and risk taking behavior (Wiseman and Catanach Jr, 1997).

*An analysis of literature suggests that the theoretical foundation of operational risk has evolved from the field of strategic management research.*

*Although there is in-sufficient academic literature that explicitly gives theoretical foundation of operational risk, there are considerable works of strategists that can be utilised to establish a conceptual framework of operational risk for financial firms[acharyya2012current, pg. 8].*

## Overview of operational risk management

It is important to note how OpRisk manifests itself; King (2001) establishes the causes and sources of operational events are observed phenomena associated with operational errors and are wide ranging. As such, P&L volatility is not only related to the way firms finance their business, but also in the way they *operate*. These operational events are almost always initiated at the dealing phase of a trading process. OpRisk management undertakes a broad view of P&L attribution carried out from deal origination to settlement within the perspective of strategic management and detects the interrelationships between operational risk factors with others to conceptualise the potential overall consequences (Acharyya, 2012).

we assume that looking at or on hearing an instruction we are consciously analysing and accurately executing it based on the information that our senses reveal. However, this isn't entirely true in OpRisk because operational events that occur indicate that they were experienced before one is consciously aware of them e.g., during the trading process in cases where OpRisk events occur as a result of a

mismatch between the trade booked (booking in trade feed) and the details agreed by the trader; human error (a sub-conscious phenomenon) is usually quoted as the source of error, and the trade is fixed by “amending” or manually changing the trade details.

Furthermore, Acharyya (2012) recognised that organizations may hold OpRisk due to external causes, such as failure of third parties or vendors (either intentionally or unintentionally), in maintaining promises or contracts. The criticism in the literature is that no amount of capital is realistically reliable for the determination of RC as a buffer to OpRisk, particularly the effectiveness of the approach of capital adequacy from external events, as there is effectively no control over them.

Despite the reality that OpRisk does not lend itself to scientific analysis in the way that market risk and credit risk do, someone must do the analysis, value the RC measurement and hope the market reflects this. Besides, financial markets are not objectively scientific, a large percentage of successful people have been lucky in their forecasts, it is not an area which lends itself to scientific analysis.

#### *The loss collection data exercise (LCDE)*

The main challenge in OpRisk modeling is in poor loss data quantities, and low data quality. There are usually very few data points and are often characterised by high frequency low severity (HFLS) and low frequency high severity (LFHS) losses. It is common knowledge that HFLS losses at the lower end of the spectrum tend to be ignored and are therefore less likely to be reported, whereas low frequency high severity losses (LFHS) are well guarded, and therefore not very likely to be made public.

In this study, a new dataset with unique feature characteristics is developed using the official loss data collection exercise (LDCE), as defined by Committee and others (2011) for internal data. The dataset in question is at the level of indi-

vidual loss events, it is fundamental as part of the study to know when they happened, and be able to identify the root causes of losses arising from which OpRisk loss events.

The LCDE is carried out drawing statistics directly from the trade generation and settlement system, which consists of a tractable set of documented trade detail extracted at the most granular level i.e., on a trade-by-trade basis [as per number of events (frequencies) and associated losses (severities)], and then aggregated daily. The dataset is split into proportions and trained, validated and tested. The aforementioned LDCE, is an improved reflection of the risk factors by singling out the value-adding processes associated with individual losses, on a trade-by-trade level.

## **Current operational risk measurement modeling framework**

### *Loss Distribution Approach (LDA)*

The Loss Distribution Approach (LDA) is an AMA method whose main objective is to provide realistic estimates to calculate VaR for OpRisk RC in the banking sector and its business units based on loss distributions that accurately reflect the frequency and severity loss distributions of the underlying data. Having calculated separately the frequency and severity distributions, we need to combine them into one aggregate loss distribution that allows us to produce a value for the OpRisk VaR. There is no simple way of aggregating the frequency and severity distribution. Numerical approximation techniques (computer algorithms) successfully bridge the divide between theory and implementation for the problems of mathematical analysis.

The aggregated losses at time  $t$  are given by  $\vartheta(t) = \sum_{n=1}^{N(t)} X_n$  (where  $X$  represents individual operational losses). Frequency and severity distributions are esti-



imated, e.g., the poisson distribution is a representation of a discrete variable commonly used to model operational event frequency (counts), and a selection from continuous distributions which can be linear (e.g. gamma distribution) or non-linear (e.g. lognormal distribution) for operational loss severity amounts. The compound loss distribution  $\mathbf{G}(t)$  can now be derived. Taking the aggregated losses we obtain:

$$\mathbf{G}_{\vartheta(t)}(x) = Pr[\vartheta(t) \leq x] = Pr\left(\sum_{n=1}^{N(t)} X_n \leq x\right) \quad (2.1)$$

For most choices of  $N(t)$  and  $X_n$ , the derivation of an explicit formula for  $\mathbf{G}_{\vartheta(t)}(x)$  is, in most cases impossible.  $\mathbf{G}(t)$  can only be obtained numerically using the Monte Carlo method, Panjer's recursive approach, and the inverse of the characteristic function [Frachot, Georges, and Roncalli (2001); Aue and Kalkbrener (2006); Panjer (2006); & others].

After most complex banks adopted the LDA for accounting for RC, significant biases and delimitations in loss data remain when trying to attribute capital requirements to OpRisk losses (Frachot et al., 2001). OpRisk is related to the internal processes of the FI, hence the quality and quantity of internal data (optimally combined with external data) are of greater concern as the available data could be rare and/or of poor quality. Such expositions are unsatisfactory if OpRisk, as Cruz (2002) professes, represents the next frontier in reducing the riskiness associated with earnings.

#### *LDA model shortcomings*

Opdyke (2014) advanced studies intending on eliminating bias apparently due to heavy tailed distributions to further provide insight on new techniques to deal with the issues that arise in LDA modeling, keeping practitioners and academics at breadth with latest research in OpRisk VaR theory. Recent work in LDA modeling has been found wanting (Badescu, Lan, Lin, and Tang, 2015), due to the very com-

plex characteristics of data sets in OpRisk VaR modeling, and even when studies used quality data and adequate historical data points, as pointed out in a recent paper by Hoohlo (2015), there is a qualitative aspect in OpRisk modeling that is often ignored, but whose validity should not be overlooked.

Opdyke (2014), Agostini et al. (2010), Jongh, De Wet, Raubenheimer, and Venter (2015), Galloppo and Previati (2014), and others explicate how greater accuracy, precision and robustness uphold a valid and reliable estimate for OpRisk capital as defined by Basel II/III. Transforming this basic knowledge into “risk culture” or firm-wide knowledge for the effective management of OpRisk, serves as a starting point for a control function providing attribution and accounting support within a framework, methodology and theory for understanding OpRisk measurement. FI’s are beginning to implement sophisticated risk management systems similar to those for market and credit risk, linking theories which govern how these risk types are controlled to theories that govern financial losses resulting from OpRisk events.

Jongh et al. (2015) and Galloppo and Previati (2014) sought to address the shortcomings of Frachot et al. (2001) by finding possible ways to improve the problems of bias and data delimitation in operational risk management. They follow the recent literature in finding a statistical-based model for integrating internal data and external data as well as scenario assessments in an endeavor to improve on accuracy of the capital estimate.

### **A new class of models capturing forward-looking aspects**

Agostini et al. (2010) also argued that banks should adopt an integrated model by combining a forward-looking component (scenario analysis) to the historical operational VaR, further adding to the literature through their integration

model which is based on the idea of estimating the parameters of the historical and subjective distributions and then combining them by using the advanced CT.

The idea at the basis of CT is that a better estimation of the OpRisk measure can be obtained by combining the two sources of information: The historical loss data and expert's judgements, advocating for the combined use of both experiences. Agostini et al. (2010) seek to explain through a weight called the credibility, the amount of credence given to two components (historical and subjective) determined by statistical uncertainty of information sources, as opposed to a weighted average approach chosen on the basis of qualitative judgements.

Thus generating a more predictable and forward looking capital estimate. He deemed the integration method as advantageous as it is self contained and independent of any arbitrary choice in the weight of the historical or subjective components of the model.

*Applicability of EBOR methodology for capturing forward-looking aspects of ORM*

Einemann et al. (2018), in a theoretical paper, construct a mathematical framework for an EBOR model to quantify OpRisk for a portfolio of pending litigations. Their work unearths an invaluable contribution to the literature, discussing a strategy on how to integrate EBOR and LDA models by building hybrid frameworks which facilitate the migration of OpRisk types from a classical to an exposure-based treatment through a quantitative framework, capturing forward looking aspects of BEICF's (Einemann et al., 2018).

The fundamental premise of the tricky nature behind ORMF, is to provide an exposure-based treatment of OpRisk losses which caters to modeling capital estimates for forward-looking aspects of ORM due to the lag in the loss data. By the very nature of OpRisk, there is usually a significant lag between the moment the OpRisk event is conceived to the moment the event is observed and accounted.i.e.,

there is a gap in time between the moment the risk is conceived and the realised losses. This timing paradox often results in questionable capital estimates, especially for those near misses, pending and realised losses that need to be captured in the model.

Exposure is residual risk, or the risk that remains after risk treatments have been applied. In the ORMF context, it is defined as:

*Definition of exposure*

The **exposure** of risk type  $i$ ,  $d_i$  is the time interval, expressed in units of time, from the initial moment when the event happened, until the occurrence of a risk correction.

*Definition of rate*

The **rate** is defined as mean count per unit exposure, i.e.

$$\begin{aligned} R &= \frac{\mu}{\tau} \quad \text{where} \quad R = \text{rate}, \quad \tau = \text{exposure, and} \\ \mu &= \text{mean count over an exposure duration of } \tau \end{aligned} \quad (2.2)$$

## Intepretation

In turn, with reference to 3, the fundamental premise behind the LDA is that each firm's OpRisk losses are a reflection of it's underlying Oprisk exposure. In particular, the assumption behind the use of the poisson model to estimate the frequency of losses, is that both the the intensity (or rate) of occurrence and the opportunity (or exposure) for counting are constant for all available observations.

The measure of exposure we need to use depends specifically on projecting the number of OpRisk event types (frequency of losses) and is different to the measure if the target variable were the severity of the losses. We need historical exposure for experience rating because we need to be able to compare the loss experience of different years on a like-for-like basis and to adjust it to current exposure levels (Parodi, 2014).

When observed counts all have the same exposure, modeling the mean count  $\mu$  as a function of explanatory variables  $x_1, \dots, x_p$  is the same as modeling the rate  $R$ .

## Benefits and Limitations

These approaches in 2, were found to have significant advantages over conventional LDA methods, proposing that an optimal mix of the two modeling elements could more accurately predict OpRisk VaR over traditional methods. Particularly Agostini et al. (2010), whose integration model represents a benchmark in OpRisk measurement by including a component in the AMA model that is not obtained by a direct average of historical and subjective VaR.

Instead, the basic idea of the integration methodology in 2 is to estimate the parameters of the frequency and severity distributions based on the historical losses and correct them; via a statistical theory, to include information coming from the scenario analysis. The method has the advantage of being completely self contained and independent of any arbitrary choice in the weight of the historical or subjective component of the model, made by the analyst. The components weights are derived in an objective and robust way, based on the statistical uncertainty of information sources, rather than through risk managers choices based on qualitative motivations.

However, they could not explain the prerequisite coherence between the historical and subjective distribution function needed in order for the model to work; particularly when a number of papers (Chau, 2014), propose using mixtures of (heavy tailed) distributions commonly used in the setting of OpRisk capital estimation (Opdyke, 2014).

In 3, their model (Einemann et al., 2018) is particularly well-suited to the specific risk type dealt with in their paper i.e., the portfolio of litigation events, due to better usage of existing information and more plausible model behavior over the litigation life cycle, but is bound to under-perform for many other OpRisk event types, since these EBOR models are typically designed to quantify specific aspects of OpRisk - litigation risk have rather concentrated risk profiles. However, EBOR models are important due to wide applicability beyond capital calculation and its potential to evolve into an important tool for auditing process and early detection of potential losses.

### **Gap in the Literature**

There is cognitive pressure which seeks to remove information which we are largely unaware of, because they are undetectable to human senses that no one could ever see them. We seek to remove this pressure, effectively lowering uncertainty and allowing us to position ourselves to develop a defense against our cognitive biases. It is through patterns in that information that we are largely unaware of that predictions could arise; or that, OpRisk management incorporates rather than dismiss the many alternatives that were not imagined, the possibility of market inefficiencies or finding value in unusual places.

## Conclusion

A substantial body of evidence suggests that loss aversion, the tendency to be more sensitive to losses than to gains plays an important role in determining how people evaluate risky gambles. In this paper we evidence that human choice behaviour can substantially deviate from neoclassical norms.

PT takes into account the loss avoidance agents and common attitudes toward risk or chance that cannot be captured by EUT; which is not testing for that inherent bias, so as to expect the probability of making the same operational error in future to be overcompensated for i.e., If an institution suffers from an OpRisk event and survives, it's highly unlikely to suffer the same loss in the future because they will over-provide for particular operational loss due to their natural risk aversion. This is a testable proposition which fits normal behavioral patterns and is consistent with risk averse behaviour.

## CHAPTER 3

### EXPOSURE-BASED OPERATIONAL RISK ANALYSIS

#### Introduction

The fundamental premise in the nature behind ORMFs, is to provide an exposure-based treatment of OpRisk losses which caters to modeling capital estimates for forward-looking aspects of ORM. This proves tricky due to the lag between the time the loss event occurs and the actual realised loss, i.e. by the very nature of OpRisk, there is a significant lag between the moment the OpRisk event is conceived to the moment the event is observed and accounted for. There is a gap in time between  $\tau$  the moment the risk is conceived and the time  $\tau + 1$  when impact of the loss is realised. This timing paradox often results in questionable capital estimates, especially for those near misses, pending and realised losses that need to be captured in the model.

#### *EBOR methodology for capturing forward-looking aspects of ORM*

Einemann et al. (2018), in a theoretical paper, construct a mathematical framework for an EBOR model to quantify OpRisk for a portfolio of pending litigations. Their work unearths an invaluable contribution to the literature, discussing a strategy on how to integrate EBOR and LDA models by building hybrid frameworks which facilitate the migration of OpRisk types from a *classical* to an exposure-based treatment through a quantitative framework, capturing forward looking aspects of BEICF's (Einemann et al., 2018), a key source of the OpRisk data.



The measure of exposure we need to use depends specifically on projecting the number of Oprisk event types (frequency of losses) and is different to the measure if the target variable were the severity of the losses. We need historical exposure for experience rating because we need to be able to compare the loss experience of different years on a like-for-like basis and to adjust it to current exposure levels (Parodi, 2014).

With reference to section 3, the fundamental premise behind the LDA is that each firm's OpRisk losses are a reflection of its underlying Oprisk exposure. In particular, the assumption behind the use of the poisson model to estimate the frequency of losses, is that both the intensity (or rate) of occurrence and the opportunity (or exposure) for counting are constant for all available observations.

### Generalised Linear Models (GLM's)

Operational riskiness in FIs grows as trading transactions grow in complexity, i.e. the more complex and numerous activity builds the higher the rate of which new cases occur at. Therefore, the rate of the hazard increases exponentially over time. The scientifically interesting question is whether the data provides any evidence that the increase in the underlying hazard generation is slowing.

Hence if  $\mu$  is the (rate) number of expected new events on day  $\tau_i$ , then

$$\mu = \gamma \exp(\delta \tau_i)$$

can be used as a model, where  $\gamma$  and  $\delta$  are unknown parameters. Taking a log link turns the model into Generalised Linear Model (GLM) form so that:

$$\log(\mu) = \log(\gamma) + \delta \tau_i = \beta_0 + \tau_i \beta_1 \tag{3.1}$$

Where the LHS is the rate of hazard over time  $\tau$  and  $\tau + 1$ , and the RHS is a linear in the parameters  $\beta_0 = \log(\gamma)$  and  $\beta_1 = \delta$ .

Since the poisson means are low; LossIndicator values are 1 for realised losses and 0 for pending losses, or near misses. Amending the model so other situations other than unrestricted spread of “rogue” events are represented, adapted to the poisson case yields:

$$\mu = d_i \exp(\beta_0 + \beta_1 \tau_i + \beta_2 \tau_i^2) \quad (3.2)$$

#### *GLM for count data*

The LHS of a GLM formula is the model’s random component which shows the number of events per trading transaction over FI’s portfolio; of which it is an observation given by the independent random variable  $Y$ , not i.i.d (Wood, 2006, and @covrig2015using).  $Y$  takes a (exponential) family argument, depending on parameters  $\lambda$  who represents the average frequency of operational events. It is worth distinguishing between the response data  $y$  which is an observation of  $Y$ .

#### *A poisson regression operational hazard model*

The target variable (LossIndicator) is a count, therefore the poisson distribution is a reasonable distribution to try. It’s probability mass function is:

$$Y \sim \text{poisson}(\lambda), \quad f(y; \lambda) = \frac{\lambda^y}{y!} \exp(-y) \quad (3.3)$$

where  $y \in \mathbb{N}$ , and  $\lambda > 0$

the expectation and variance  $E[Y] = \text{VaR}[Y] = \lambda$  If you were to guess an independent  $Y_i$  from a random sample, the best guess is given by this expression are equal to parameter  $\lambda$ .

The RHS is the model's systematic component, and specifies the linear predictor. It builds on equation 3.2 with  $p + 1$  parameters  $\beta = (\beta_0 \dots, \beta_p)^t$  with  $p$  explanatory variables:

$$\nu = \beta_0 + \sum_{j=1}^p \beta_j x_{ij}, \quad \text{where } i = 1, \dots, n \quad (3.4)$$

If sample variables  $Y_i \sim \text{Poisson}(\lambda_i)$ , then  $\mu = E[Y_i] = \lambda_i$ ; the link function between the random and systematic components, viz. a transformation by the model by some function  $g()$ , which does not change features essential to fitting, but rather a scaling in magnitude so that:

$$\begin{aligned} \nu_i &= g(\lambda_i) = \ln \lambda_i, & \text{that is} \\ \nu &= \beta_0 + \sum_{j=1}^p \beta_j x_{ij} \end{aligned} \quad (3.5)$$

so the mean frequency or otherwise the rate  $R$ , will be predicted by the model...

$$\begin{aligned} \lambda_i &= d_i \exp(\beta_0 + \sum_{j=1}^p \beta_j x_{ij}) \quad \text{or} \\ \lambda_i &= d_i \cdot e^{\beta_0} \cdot e^{\beta_1 x_{i1}} \cdot e^{\beta_2 x_{i2}} \dots e^{\beta_p x_{ip}} \end{aligned} \quad (3.6)$$

Where  $d_i$  represents the risk exposure for transaction  $i$ . Taking logs on both sides of equation 3.6, the regression model for the estimation of loss frequency is:

$$\ln \lambda_i = \ln d_i + \beta_0 + \beta_1 x_{i1} + \beta_2 x_{i2} + \dots + \beta_p x_{ip} \quad (3.7)$$

where  $\ln d_i$  is the natural log of risk exposure, called the “offset variable”.

## **Research Objective 1**

To introduce a generalised additive model for location, scale and shape (GAMLSS) framework for OpRisk management, that captures exposures to forward-looking aspects of the OpRisk loss prediction problem, due to deep hierarchies in the features of covariates in the investment banking (IB) business environment, and internal control risk factors (BEICF) thereof.

## **Limitations of the EBOR model**

In their model (Einemann et al., 2018), definition 2 is particularly well-suited to the specific risk type dealt with in their paper i.e., the portfolio of litigation events, due to better usage of existing information and more plausible model behavior over the litigation life cycle, but is bound to under-perform for many other OpRisk event types, since these EBOR models are typically designed to quantify specific aspects of OpRisk - litigation risk have rather concentrated risk profiles. Furthermore, EBOR models are important due to wide applicability beyond capital calculation and its potential to evolve into an important tool for auditing process and early detection of potential losses.

## **Exploratory data analysis**

The main source of the analysis dataset is made up of internal losses for the period between 1 January 2013 and 31st March 2013 at a FI. The method of data generation and collection is at the level of the individual trade deal, wherein deal information is drawn directly from the trade generation and and settlement system (TGSS) and edit detail from attribution reports generated in middle office profit & loss (MOPL). The raw source consists of two separate datasets on a trade-by-trade

basis of daily frequencies (number of events) and associated loss severities.

The raw frequency data consists of 58,953 observations of 15 variables, within the dataset there are 50,437 unique trades. The raw severity data consists of 6,766 observations of 20 variables, within the severity dataset there are 2,537 unique trades. The intersection between the frequency and severity datasets consists of 2,330 individual transactions which represent realised losses, pending and/or near misses. This dataset is comprised of 3-month risk correction detail, in the interval between 01 January 2013 and 31 March 2013.

**Table 3.1:** The contents of the traded transactions of the associated risk correction events.

Covariate	Storage	
	Levels	Type
Trade		numeric
UpdateTime		numeric
UpdatedDay		numeric
UpdatedTime		numeric
TradeTime		numeric
TradedDay		numeric
TradedTime		numeric
Desk	10	categorical
CapturedBy	5	categorical
TradeStatus	4	categorical
TraderId	7	categorical
Instrument	23	categorical
Reason	19	categorical
Loss		numeric
EventTypeCategoryLevel	5	categorical
BusinessLineLevel	8	categorical
LossIndicator	2	binary
exposure		numeric

Two new variables are derived from the data; a target variable (LossIndicator) is a binary variable whereupon, a 1 signifies a realised loss, and 0 for those pending

losses, or near misses. The *exposure* variable is computed by deducting the time between the trade amendment (UpdateTime) and the time when the trade was booked. It is measure that is roughly proportional to the risk of the transaction or a group of transactions. The idea is that if the exposure (e.g. the duration of a trade, the number of allocation(trade splits), etc.) doubles whilst everything else (e.g. the rate, nominal of the splits, and others) remains the same, then the risk also doubles.

In R, the GLM function works with two types of covariates/explanatory variables: numeric (continuous) and categorical (factor) variables as depicted in table 3.1. Multi-level categorical variables are recoded by building dummy variables corresponding to each level. This is achieved through an implemented algorithm in R, through a transformation as recommended for the estimation of the GLM, particularly in the estimation of the poisson regression model for count data.

The model revolves around the fact that for each categorical variable (covariate), previously transformed into a dummy variable, one must specify a reference category from which the corresponding observations under the same covariate are estimated and assigned a weight against in the model (Covrig et al., 2015). By default in the GLM, the first level of the categorical variable is taken as the reference level. As best practice, De Jong, Heller, and others (2008), Frees and Sun (2010), Denuit, Maréchal, Pitrebois, and Walhin (2007), Cameron and Trivedi (2013) recommend that for each categorical variable one should specify the modal class as the reference level; as this variable corresponds to the level with the highest order of predictability, excluding the dummy variable corresponding to (weight coefficient = 1) the biggest absolute frequency.

### *Interpretation*

Table 3.2 presents the various units produced for the various GLM links.

**Table 3.2:** The generalized linear model link functions with their associated units of interpretation. Note: This list is not exhaustive and there are likely more GLMs that are used within prevention research.

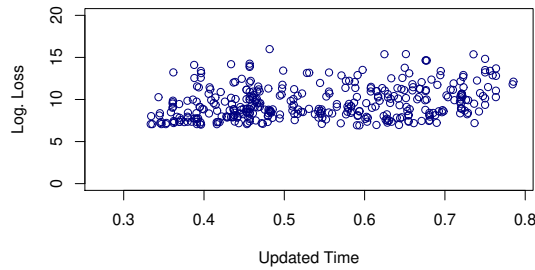
Link Function	Average Marginal Effect
Identity	Original Continuous Unit
Log	Original Continuous Unit
Logit	Risk
Probit	Risk
Poisson	Count
Gamma	Count
Negative Binomial	Count

The poisson distribution is restrictive due to the assumption made that the mean and variance of the number of events are equal. However, models for count data where means are low so that the number of zeros and ones in the data is excessive are well adapted to the poisson case (Wood, 2006). They characterise situations in OpRisk other than models when the unchecked spreading of negligent behaviour may result in an operational hazard. The negative binomial and/or quasipoisson regression models ascribe to data that exhibits *overdispersion*, wherein the variance is much larger than the mean for basic count data, therefore they have been eliminated in this paper.

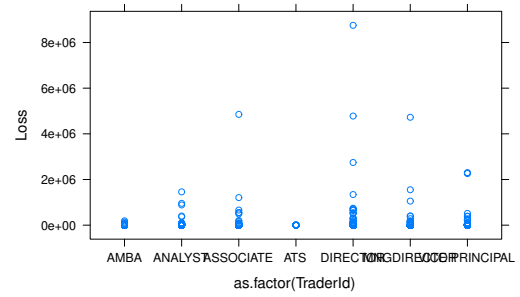
## Description of the dataset

In this section, section 3, the dataset called *OpRiskDataSet\_exposure*, provides data on the increase in the numbers of operational events over a three month period, beginning 01 January 2013 to end of 20 March 2013. For each transaction, there is information about: trading risk exposure, trading characteristics, causal

## Intra-day Trend of Loss Severity



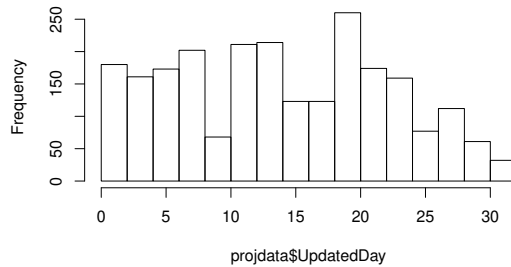
## Trends of Loss Severities per Trader



(a) Scatterplots showing the totals of the number loss corrections and the number of trades per month

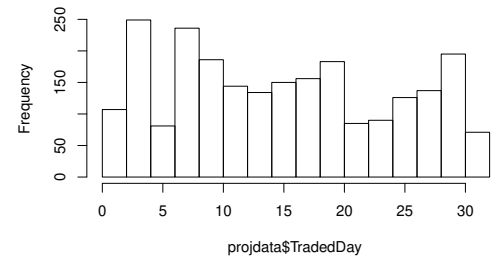
## Histogram of Monthly Loss Frequencies

Histogram of projdata\$UpdatedDay



## Histogram of Monthly Trade Frequencies

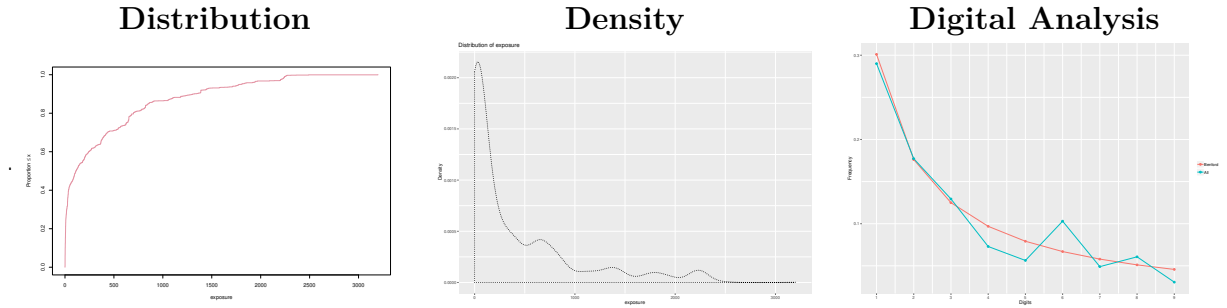
Histogram of projdata\$TradedDay



(b) Histograms showing the totals of the number loss corrections and the number of trades per month

**Figure 3.1:** (a) Scatterplots of intra-day trend analysis for logs of severities of operational events and trends incident activity for identifying the role of the trader originating the incidents. (b) As for (a) but in the form of histograms showing the frequency distribution of the number daily operational incidents and the number of trades over a monthly period.





**Figure 3.2:** A simple comparison of the Sigmoidal like features of the fat-tailed, right skewed distribution for exposure, and first-digit frequency distribution from the exposure data with the expected distribution according to Benford's Law

factor characteristics and their cost.

### *Characteristics of exposure*

The exposure of risk of type  $i$ ,  $d_i$  shows the daily duration, from when the trade was booked to the moment the operational risk event was observed and ended. This measure is defined this way when specifically applied to projecting the number of loss events (frequencies) and can be plotted as follows depicted in graphs 3.2.

The variable follows a logistic trend on  $[0, 1]$ , implying an FI's operational risk portfolio rises like a sigmoid function throughout the period of observation, typically starting from 0, which then observes a plateau in growth. The average exposure is 389.99 or about 1 year.

Grid plots 3.2 portray the logistic function, together with a simple comparison of first-digit frequency distribution analysis, according to Benford's Law, with exposure data distribution. The close fitting nature implies the data are uniformly distributed across several orders of magnitude, especially within the 1 year period.



The continuous numerical variable *Loss*, shows the financial impact (severity) of the OpRisk incident in Rands, for the most part, (96.1%) incidents result in pending losses and near misses, most realised losses (2.3%) lie within [R200,00, R300,000] range, in the portfolio there are also 5 p&L impacts higher than R2.5 million.

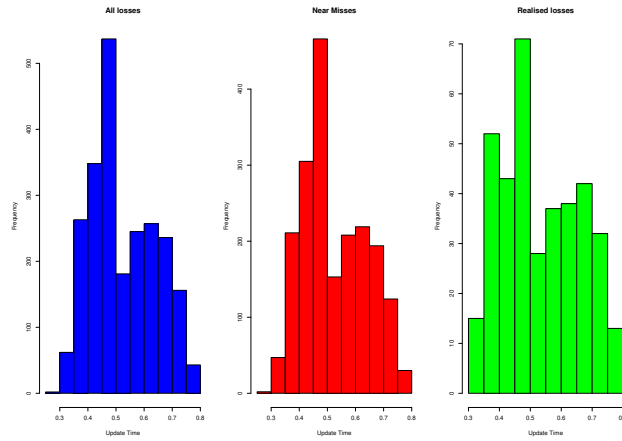
### *Characteristics of daily operational activity*

The distribution of daily losses and/or pending/near misses by operational activities are represented in 3.3. Figure 3.3a shows that most operational events occur in times leading up to midday (i.e. 10:50AM to 11:50AM), the observed median is 11:39AM, and of these potential loss events, most realised losses occur closest to mid-day. The frequencies of the loss incidents in the analysed portfolio sharply decreases during the following period, i.e. from 12:10PM to 13:10PM, during which the least realised losses occur.

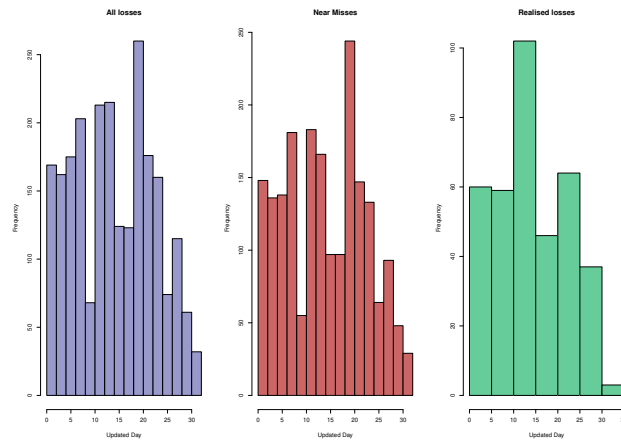
Figure 3.3b shows that operational activity increases in intensity in the days leading up to the middle of the month, i.e. 10<sup>th</sup> - 15<sup>th</sup>; the observed mean is 14.49 days, and of these potential loss events, realised losses especially impact on the portfolio during these days.

Similarly, the influence of trading desk's on the frequency of operational events can be analysed on the basis of the portfolio's bidimensional distribution by variables *Desk* and *LossIndicator*, which shows the proportions realised losses vs pending and/or near misses for each particular desk. The bidimensional distribution of *Desk* and *LossIndicator* is presented in a contingency table, Table 3.3, in which it's considered useful to calculate proportions for each desk category.

Thus, as illustrated in figure 3.4, from 23,5%; the highest proportion of realised losses per desk is the Money Market (MM) desk, the figures are decreasing, followed by Prime Services (22%); Bonds/Repos (21,5%); Equity (19,7%); Africa



(a) Frequency distributions of operational incidents by the time in the day

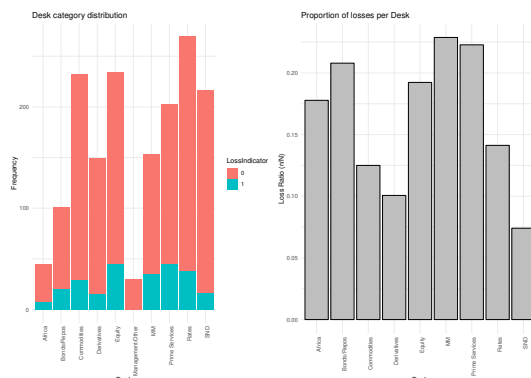


(b) Frequency distributions of operational incidents by the day in the month

**Figure 3.3:** The frequency distributions of All the losses, the realised losses, and pending/near misses of operational incidents by the day in the month when the incidents' occurred

**Table 3.3:** Occurence of realised losses: proportions on desk categories

Desk	No. of transactions		
	no Loss	Loss	Total
Africa	49	10	59
Bonds/Repos	113	31	144
Commodities	282	45	327
Derivatives	205	24	229
Equity	269	66	335
Management/Other	41	2	43
Money Market	169	52	221
Prime Services	220	62	282
Rates	336	53	389
Structured Notes	275	26	301

**Figure 3.4:** Histograms showing the proportions of realised losses vs all losses including pending and/or near misses by desk category

(16,9%); Commodities (13,8%); Rates (13,6%); Derivatives (10,5%); Structured Notes (SND) (8,6%), to the least proportion in the Management/Other, a category where only 4,7% of operations activities were realised as losses.

This behaviour can be extended beyond the trading desk, as represented in Figure 3, a mosaic plot grid presenting the structure of the OpRisk portfolio by Instrument, TraderId, CapturedBy <sup>2</sup> and the operational losses.

<sup>2</sup>i.e. the type of financial instrument, the trader who originated the incident on the deal, and the role of the technical support personnel who is involved in the query resolution.

Mosaic grid plots for the bidimensional distribution by traded instrument, the trader originating the operational event, and by the technical support personnel involved in query resolution, against the dummy variable showing if a realised loss was reported.

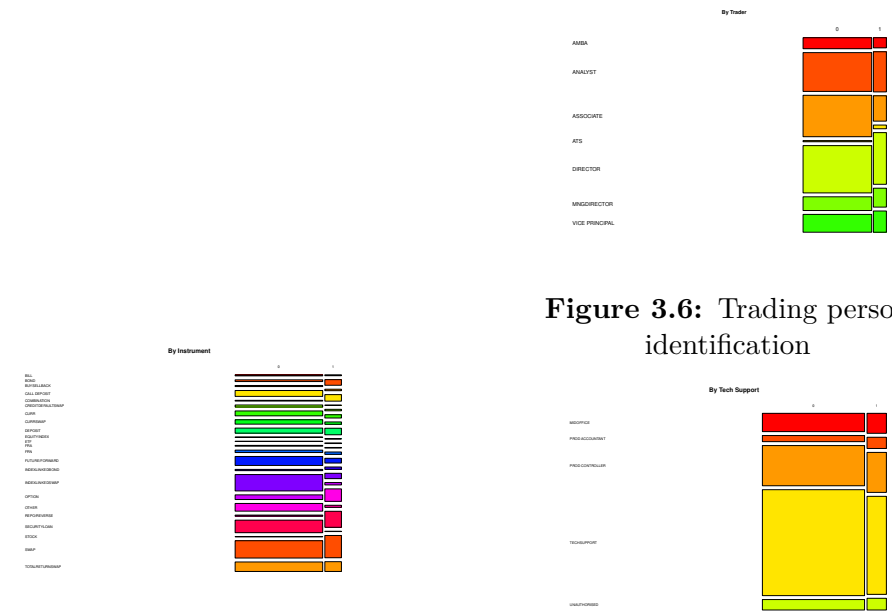


Figure 3.5: Type of Instrument traded

Figure 3.7: Technical support staff function

One can notice that the width of the bars corresponding to the different categories, i.e. Instrument, TraderId, CapturedBy, is given by their proportion in the sample. In particular, for the category ‘at least one realised loss’, Figure 3.6 portrays a increase “riskiness” trending up from Associate to AMBA, Analyst, Vice Principal, Managing Director, Director, up to the risky ATS category, which are automated trading system generated trades.

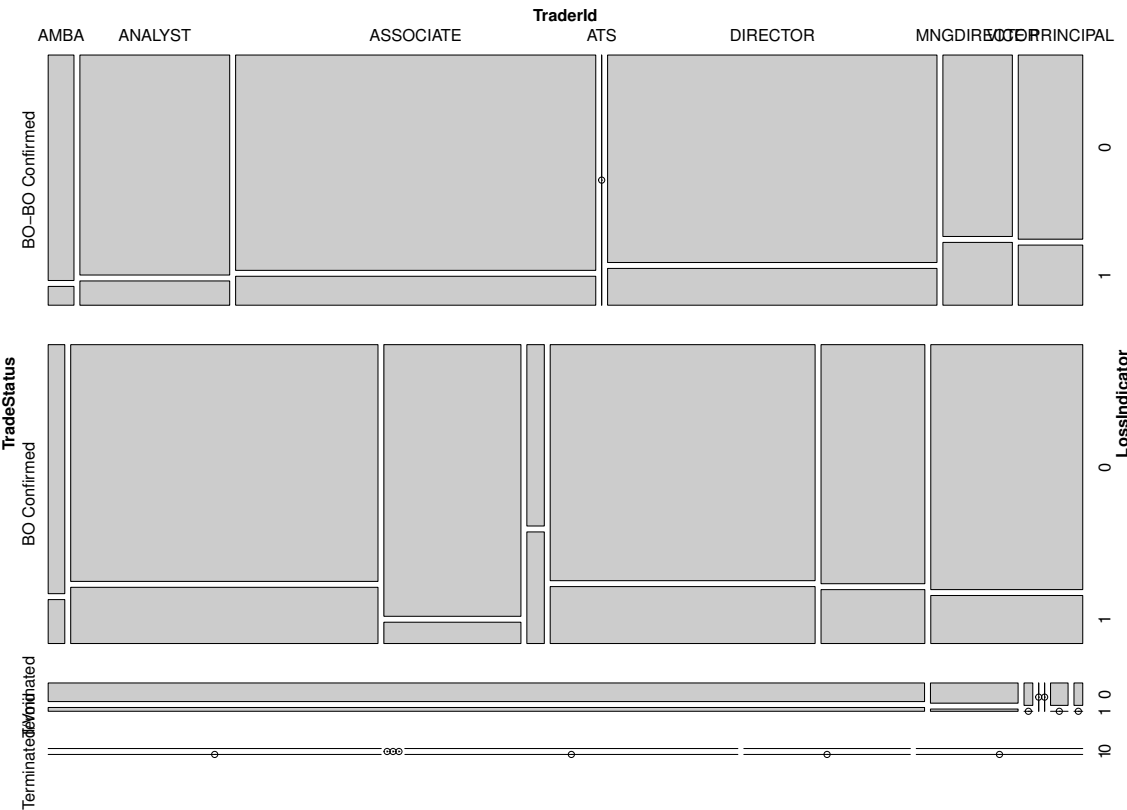
Figure 3.7 for the category ‘at least one realised loss’, portrays a decreasing trend, slowing in riskiness from Unauthorised users downward to Tech Support, Mid Office, Prod controller down to the least risky Prod Accountant. This interpretation makes sense given unauthorised users are more likely to make impactful operational errors, technical support personnel would also be accountable for large impacts albiet for contrasting reasons, they are mandated to perform these deal adjustments which have unavoidable impacts associated with them, whereas the former group are unauthorised to perform adjustments therefore may lack the skill, or may have more devious intentions in their actions.

In another mosaic plot, (3.8), the bidimensional distribution of transactions by trader and realised vs pending losses, conditional on the trade stautus in presented and analysed. Here, and in the contingency table, Table 3.5, we can clearly see the trends: in BO-BO confired status - an increasing realised losses from left (AMBA) to right, and the opposite for transaction performed in BO Confirmed status. Particularly, the biggest number of realised losses in both BO and BO-BO Confirmed statuses are for automated trading systems (ATS).

Table 3.5 and Figure 3.8 are obtained with the following commands:

```
library(vcd)
STD <- structable(~TradeStatus + TraderId + LossIndicator
                  , data = projdata)
MS01 <- mosaic(STD, condvars = 'TradeStatus', col=rainbow(20),
               split_horizontal = c(TRUE, FALSE, TRUE))
```

Mosaic plot for trader identification and loss indicator, by trade status



**Figure 3.8:** A mosaic plot representing the structure of the operational risk portfolio by trader identification (TraderId), the status of the trade (TradeStatus) and the number of realised losses vs pending or near misses

Table 3.4 presents the most frequent category in the operational risk dataset for each possible covariate.

The estimation of some poisson regression models

Section 3 introduced a model for the start of the expected number of operational events in the early stages. We aim to estimate the mean OpRisk frequency through a poisson classification model given by equation 3.3 using the glm function. The mean daily loss frequency in the risk correction statistics is estimated through



### Crosstab of trader identification and loss indicator, by trade status

TradeStatus	Loss Indicator	Trader Identification						
		Amba	Analyst	Associate	ATS	Director	Mng Director	Vice Principal
BO-BO Confirmed	0	24	136	320	0	282	52	49
	1	2	15	43	0	50	18	16
BO Confirmed	0	17	299	153	13	257	102	153
	1	3	71	12	8	62	23	30
Terminated	0	83	9	1	0	0	2	1
	1	17	1	0	0	0	0	0
Terminated/Void	0	2	0	0	0	2	1	1
	1	0	0	0	0	0	0	0

**Table 3.4:** A contingency table showing the bidimensional distribution of transactions by trader identification vs realised and/or pending losses, conditional on the trade status

### Modal classes for the categorical variables

Variable	Modal class or category	Name of modal class
Desk	Rates	DeskRates
CapturedBy	TECHSUPPORT	CapturedBy_TECHSUPPORT
TradeStatus	BO confirmed	TradeStatus_BO confirmed
TraderId	DIRECTOR	TraderId_DIRECTOR
Instrument	Swap	Instrument_Swap
Reason	Trade enrichment for system flow	Reason_Trade enrichment for system flow
EventTypeCategoryLevel	EL7	EventTypeCategoryLevel_EL7
BusinessLineLevel	BL2	BusinessLineLevel_BL2

**Table 3.5:** A contingency table showing the bidimensional distribution of transactions by trader identification vs realised and/or pending losses, conditional on the trade status

the poisson regression model. Let us consider a model where the *LossIndicator* is the target variable: The following fits the model (the log link is canonical for the poisson distribution, and hence the R default) and checks it.

## CHAPTER 4

### METHODS FOR MODELING OPRISK DEPENDING ON COVARIATES

#### Introduction

This section of the paper concentrates on combining various supervised learning techniques with extreme value theory (EVT) fitting, which is very much based on the Dynamic EVT-POT model developed by Chavez-Demoulin et al. (2016). This can only happen due to an abundance of larger and better quality datasets and which also benefits the loss distribution approach (LDA) and other areas of OpRisk modeling. In Chavez-Demoulin et al. (2016), they consider dynamic models based on covariates and in particular concentrate on the influence of internal root causes that prove to be useful from the proposed methodology.

Motivated by the abundance of data and better data quality, these new data-intensive techniques offer an important tool for ORM and at the same time supporting the call from industry for a new class of EBOR models that capture forward-looking aspects of ORM (Embrechts et al., 2018). Three different machine learning techniques viz., decision trees, random forest, and neural networks, will be employed using R. A comprehensive list of user defined variables associated with root causes that contribute to the accumulation of OpRisk events (frequency) has been provided, moreover, a lot can be gained from this dataset as it also bears the impacts of these covariates on the severity of OpRisk.

#### *Modeling Oprisk: The loss distribution approach (LDA)*

Twenty-one key risk indicators (kri's) with eight feature groups including person identification, trade origination, root causes and market value sensitivities are in the chosen covariates. For each risk event there is information about: trading risk exposure, trading characteristics, causal factor characteristics and the losses created by these factors. The development, training and validation of the machine learning (ML) models lends itself to this new type of data and requires a higher degree of involvement across operations. Moreover, at this level of granularity the different types of data is particularly suited to exposure-based treatment, and other forward-looking aspects within the OpRisk framework, for improved forecasts of OpRisk losses.

The aggregated operational losses can be seen as a sum  $S$  of a random number  $N$  individual operational losses

$$(X_1, \dots, X_N)$$

. The total required capital is the sum of VaR of each BL/ET combination calibrated through the underlying mathematical model whose analytic expression is

given by:

$$\mathbf{G}_{\vartheta(t)}(x) = Pr[\vartheta(t) \leq x] = Pr\left(\sum_{n=1}^{N(t)} X_n \leq x\right), \quad \text{where } \vartheta(t) = \sum_{n=1}^{N(t)} X_n. \quad (4.1)$$

$\mathbf{G}(t)$  can only be obtained numerically using the Monte Carlo method, Panjer's recursive approach, and the inverse of the characteristic function (Frachot et al. (2001); Aue and Kalkbrener (2006); Panjer (2006); & others).

### *Research Objective 2*

To test the accuracy of several classes of data-intensive techniques in approximating the weights of the risk factors; i.e., the input features of the model viz., TraderID, UpdatedDay, Desk, etc. of the underlying value-adding processes, against traditional statistical techniques, in order to separately estimate the frequency and severity distribution of the OpRisk losses from historical data. As a consequence, capital estimates should be able to adapt to changes in the risk profile e.g., upon the addition of new products or varying the business mix of the bank (e.g., terminations, voids, allocations, etc.) to provide sufficient incentives for ORM to mitigate risk (Einemann et al., 2018).

### **Theoretical investigations for the quantification of modern ORM**

Within the variety of relations among risk preferences, people have difficulty in grasping the concept of risk-neutrality. In a market where securities are traded, risk-neutral probabilities are the cornerstone of trade, due to their importance in the law of no arbitrage for securities pricing. Mathematical finance is concerned with pricing of securities, and makes use of this idea: That is, assuming that arbitrage activities do not exist, two positions with the same pay-off must also have an identical market value (Gisiger, 2010). A position (normally a primary security)

can be replicated through a construction consisting of a linear combination of long, as well as short positions of traded securities. It is a relative pricing concept which removes risk-free profits due to the no-arbitrage condition.

This idea seems quite intuitive from an OpRisk management perspective. The fact that one can take internal historical loss data and use this to make a statement on the OpRisk VaR measure for the population, is based on the underlying assumption of risk neutrality. Consider a series of disjoint risky events occurring at times  $\tau$  to  $\tau + 1$ . We can explore the concept of a two state economy in which value is assigned to gains and losses, rather than to final assets, such that an incremental gain or loss can be realised at state  $\tau + 1$ , contingent on the probability which positively impacts on the event happening.

#### *Risk-neutral measure $\mathbb{Q}$*

Risk-neutral probabilities simply enforce a linear consistency for views on equivalent losses/gains, with regard to the shape of the value function. The shape the graph depicts a linear relationship based on responses to gains/losses and value. The risk neutral probability is not the real probability of an event happening, but should be interpreted as (a functional mapping) of the number of loss events (frequency).

Suppose we have:  $\Theta$  = Gain/Loss;  $\nu(x)$  = risk event happening; and  $X$  = Individual gain/loss (or both), then;

$$\Theta = \sum_{i=1}^n \Pr[\nu(x_i)] * X_i \quad (4.2)$$

where

$$\sum_{i=1}^n \Pr[\nu(x_i)] = 1 \quad \text{and} \quad \Pr[\nu(x_i)] \geq 0 \quad \forall i$$

Note that the random variable  $\Theta$  is the sum of the products of frequency and severity for losses (in OpRisk there are no gains).

This formula is used extensively in actuarial practices, for decisions relating to quantifying different types of risk, in particular in the quantification of value-at-risk (VaR) (a risk measure used to determine capital adequacy requirements, commonly adopted in the banking industry). A quantile of the distribution of the aggregate losses is the level of exposure to risk, expressed as VaR.

People exhibit a specific four-fold behaviour pattern when facing risk (Shefrin, 2016). There are four combinations of gain/loss and moderate/extreme probabilities, with two choices of risk attitude per combination. OpRisk measurement focuses on only those casual factors that create losses with random uncertainty, for the value adding processes of the business unit.

## CHAPTER 5

THEORETICAL INVESTIGATIONS INTO THE QUANTIFICATION OF  
MODERN ORMF'S**Theoretical investigations for the quantification of modern ORM**

Within the variety of relations among risk preferences, people have difficulty in grasping the concept of risk-neutrality. In a market where securities are traded, risk-neutral probabilities are the cornerstone of trade, due to their importance in the law of no arbitrage for securities pricing. Mathematical finance is concerned with pricing of securities, and makes use of this idea.

That is, assuming that arbitrage activities do not exist, two positions with the same pay-off must also have an identical market value (Gisiger, 2010). A position (normally a primary security) can be replicated through a construction consisting of a linear combination of long, as well as short positions of traded securities. It is a relative pricing concept which removes risk-free profits due to the no-arbitrage condition.

This idea seems quite intuitive from an OpRisk management perspective. The fact that one can take internal historical loss data and use this to make a statement on the OpRisk VaR measure for the population, is based on the underlying assumption of risk neutrality. Consider a series of disjoint risky events occurring at times  $\tau$  to  $\tau + 1$ . We can explore the concept of a two state economy in which value is assigned to gains and losses, rather than to final assets, such that an incremental gain or loss can be realised at state  $\tau + 1$ , contingent on the probability which positively impacts on the event happening.

*Risk-neutral measure  $\mathbb{Q}$* 

Risk-neutral probabilities simply enforce a linear consistency for views on equivalent losses/gains, with regard to the shape of the value function. The shape the graph depicts a linear relationship based on responses to gains/losses and value. The risk neutral probability is not the real probability of an event happening, but should be interpreted as (a functional mapping) of the number of loss events (frequency).

Suppose we have:  $\Theta$  = Gain/Loss;  $\nu(x)$  = risk event happening; and  $X$  = Individual gain/loss (or both), then

$$\Theta = \sum_{i=1}^n \Pr[\nu(x_i)] * X_i \quad (5.1)$$

where

$$\sum_{i=1}^n \Pr[\nu(x_i)] = 1 \quad \text{and} \quad \Pr[\nu(x_i)] \geq 0 \quad \forall i$$

Note that the random variable  $\Theta$  is the sum of the products of frequency and severity for losses (in **OpRisk** there are no gains).

This formula is used extensively in actuarial practices, for decisions relating to quantifying different types of risk, in particular in the quantification of value-at-risk (VaR) (a risk measure used to determine capital adequacy requirements, commonly adopted in the banking industry).

A quantile of the distribution of the aggregate losses is the level of exposure to risk, expressed as VaR. People exhibit a specific four-fold behaviour pattern when facing risk (Shefrin, 2016). There are four combinations of gain/loss and moderate/extreme probabilities, with two choices of risk attitude per combination. OpRisk measurement focuses on only those casual factors that create losses with



random uncertainty, for the value adding processes of the business unit.

### *Cluster analysis*

Cluster analysis (CA) is an unsupervised machine learning technique, which sets out to group combinations of covariates according to levels of similarity into clusters. The CA algorithm attempts to optimise homogeneity within data groups, and heterogeneity between groups of observations. Thus, in the context of ORM, CA regroups these combinations of covariates into clusters (so that features within each group are similar to one another, and different from features in other groups), ordering and prioritising the root causes of losses.

A new and challenging argument can be demonstrated through clustering correlated data objects in the OpRisk dataset, by asserting that clustering should show more than one distinct group. In addition, the more groups of distinct clusters, losses are expected to drop, and losses in distinct clusters should also show a decreasing trend over time, with intensifying exposure. Ultimately, subtle patterns of frequencies and associated severities of losses in the OpRisk data can be revealed.

The OpRisk dataset is subdivided for training patterns, validated and tested with the  $k$ -means clustering algorithm. To achieve this the  $k$ -means algorithm randomly subdivides the data in  $k$  groups. Firstly, each groups mean is found by clustering the centers in the input variable-space of the training patterns. In each cluster within each group, the significant variables' coefficients which determine cluster have set centers closest to the cluster centers generated by the  $k$ -means clustering algorithm applied to the input vectors of the training data (Flake, 1998). These clusters have centers closest:- as defined by a differential metric i.e., the Euclidean distance, to a relationship (e.g. a linear combination of coefficients and variables) which most accurately predicts the target variable.

*Research Objective 3*

To identify potential flaws in the loss distribution approach (LDA) model of ORM by employing CA. The *classical* LDA model, through a mathematical framework derives a negative pay-off function (loss) based on a risk-neutral measure  $\mathbb{Q}$ . The study addresses weaknesses in the current LDA model framework, by assuming managerial risk-taking attitudes are more risk averse.

More precisely, the goal is to use CA to learn deep hierarchies of features<sup>1</sup> found during operations, to then determine whether risk adverse techniques over-compensate for persistent loss event types over time.

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<sup>1</sup>A typical approach taken in the literature is to use an unsupervised learning algorithm to train a model of the unlabeled data and then use the results to extract interesting features from the data [@coates2012learning]

## CHAPTER 6

## RESULTS

*The power of intuitive understanding will protect you from harm until the end of your days. — Lao Tzu*

**Introduction****Results**

```
## Error in eval(expr, envir, enclos): object 'da36361.0001' not found
## Error in tolower(names(d)): object 'd' not found
## Error in eval(lhs, parent, parent): object 'd' not found
## Error in map(.x, .f, ...): object 'd1' not found
## Error in map_lgl(.x, .p, ...): object 'd1' not found
## Error in eval(lhs, parent, parent): object 'd1' not found
## Error in library(here): there is no package called 'here'
## Error in here("Data/NSDUH_2014_Results.rda"): could not find function "here"
## Error in library(survey): there is no package called 'survey'
## Error in svydesign(ids = ~1, strata = ~vestr, weights = ~analwt_c, data = d1):
## Error in svyglm(self ~ religious + age2 + irsex + newrace2 + irfamin3 + : could
## Error in svyglm(peer ~ religious + age2 + irsex + newrace2 + irfamin3 + : could
## Error in svyglm(dep ~ religious + age2 + irsex + newrace2 + irfamin3 + : could
## Error in coef(obj): object 'svy_a1' not found
## Error in rownames(est1) = c("Respondent", "Peer", "Depression"): object 'est1'
## Error in data.frame(est1): object 'est1' not found
## Error in svyglm(model, design = design, family = "quasibinomial"): could not fi
## Error in vcov.default(object): object does not have variance-covariance matrix
```

```
## Error in rownames(est2) = c("Tobacco", "Rx", "Marijuana", "Illicit"): object 'e
## Error in data.frame(est2): object 'est2' not found
## Error in loadNamespace(name): there is no package called 'anteo'
```

## Conclusions

## CHAPTER 7

## DISCUSSION

*A model is a simplification or approximation of reality and hence will not reflect all of reality. ... While a model can never be “truth,” a model might be ranked from very useful, to useful, to somewhat useful, to, finally, essentially useless. — Burnham and Anderson, 2002*

**General Discussion**

*Findings from the Three Chapters*

**Limitations****Future Research****Conclusions**

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## APPENDICES

## **Appendix A: R Code for Chapter 5**

Required: R Packages from CRAN

Required: R Packages from GitHub

*Examples from Chapter 5*

Figure ?? on page ??

*Monte Carlo Simulation*

Notably, the code for both the binary mediator condition and the count mediator condition we run via the Terminal as, once the directory was where the R file was located:

```
Rscript Analyses_MMMC_scriptBinary.R 'c(1:45)'
```

and

```
Rscript Analyses_MMMC_scriptCount.R 'c(1:45)'
```

Binary Mediator

Count Mediator

*Monte Carlo Simulation Data Analyses*

Data Preparations for tables and figures around page ??

Table ?? on page ??

Figure ?? on page ??

Figures ??, ??, and ?? on pages ??, ??, and ??, respectively.

## **Appendix B: R Code for Chapter 6**

Required: R Packages from CRAN

Required: R Packages from GitHub

*Data Preparation*

Data preparation using the 2014 National Survey on Drug Use and Health, as described in Chapter 4.

```
library(tidyverse)
library(furniture)

## Load data
load("Data/NSDUH_2014_Results.rda")
d = da36361.0001
names(d) = tolower(names(d))
rm(da36361.0001)

## Variables
d1 = d %>%
  select(
    ## ----- ##
    ## Outcomes ##
    ## (1,2,8,11,12 = within last year) ##
    ## ----- ##
    ## Tobacco Outcome
    cigrec, ## cig
    chewrec, ## chew
    cigarrec, ## cigar
    #pipe30dy, ## pipe (30 days here instead)

    ## Heavy Drinking Outcome
    dr5day, ## 1+ is within last 30 days

    ## Rx Outcome
    analrec, ## pain relievers
    tranrec, ## tranquilizers
    stimrec, ## stimulants
    sedrec, ## sedatives

    ## Marijuana Outcome
    mjrec, ## marijuana

    ## Other Illicit Outcome
    cocrec, ## cocaine
    crakrec, ## crack
    herrec, ## heroin
    hallrec, ## hallucinogens
    lsdrec, ## LSD
    pcprec, ## PCP
    ecsrec, ## ecstasy
    inhrec, ## inhalants
```

```

methrec, ## meth

## ----- ##
## Mediators ##
## Mean response (higher = more cons) ##
## ----- ##
## Self Views Mediator
yegpkcig, ## someone your age cig
yegmjvr, ## someone your age mj
yegmjmo, ## someone your age mj monthly
yegaldly, ## someone your age drinking daily

## Peer Views Mediator
yefpkcig, ## you cig
yefmjvr, ## you mj
yefmjmo, ## you mj monthly
yefaldly, ## you drinking daily

## Psychological Well-being (Major Depression)
ymdeyr, ## past year major depressive episode (MDE)

## ----- ##
## Predictor ##
## Cronbach's Alpha ##
## Standardized mean level ##
## ----- ##
## Religiosity
yerlgsvc, ## past 12, times at church (1-6)
yerlgimp, ## religious beliefs are important (1-4 strong dis to strong agree)
yerldcsn, ## religious belief influence decisions (1-4)
yefaiact, ## religious activities

## ----- ##
## Control Variables ##
## ----- ##
## Parental Attitudes
yeppkcig, ## parents feel about cig
yepmjvr, ## parents feel about mj
yepmjmo, ## parents feel about mj monthly
yepaldly, ## parents feel about drinking daily

## Demographics
age2, ## age
catage, ## age category (1 = 12-17 year old)
irsex, ## gender (1 = male)
newrace2, ## race (1 = White, 2-7 non-white)
irfamin3, ## total family income (6 = 50,000 - 74,999)

```



```

poverty2, ## not used in the study but could be for ours
      ## (1 = poverty, 2 = low middle, 3 = middle class or more)

## ----- ##
## Sampling Variables      ##
## ----- ##
analwt_c, ## sample weight
vestr,    ## analysis stratum
verep     ## analysis replicate
) %>%
filter(catage == "(1) 12-17 Years Old")

## Data Cleaning
dich = function(x){
  x = ifelse(grepl("(01)|(02)|(08)|(11)", x), 1, 0)
  x
}
map_to = function(x){
  lbls = sort(levels(x))
  lbls = (sub("^\\([0-9]+\\) +(.+)$", "\\1", lbls))
  x = as.numeric(gsub("^\\([0-9]+\\) +(.+)$", "\\1", x))
  x
}
d1[, c(1:18)] = map_df(d1[, c(1:18)], ~dich(.x))
d1[, c(19:36)] = map_if(d1[, c(19:36)], is.factor, ~map_to(.x))

## Creating final modeling variables
d1 = d1 %>%
  mutate(tobacco = ifelse(rowSums(cbind(cigrec, chewrec,
                                         cigarrec)) > 0, 1, 0),

         drink    = dr5day,
         rx        = ifelse(rowSums(cbind(analrec, tranrec,
                                         stimrec, sedrec)) > 0, 1, 0),

         mari      = ifelse(mjrec == 1, 1, 0),
         illicit   = ifelse(rowSums(cbind(cocrec, crakrec,
                                         herrec, hallrec,
                                         lsdrec, pcprec,
                                         ecsrec, inhrec,
                                         methrec)) > 0, 1, 0)) %>%
  mutate(self = rowMeans(cbind(yegpkcig, yegmjever, yegmjmo, yegaldly)),
         peer = rowMeans(cbind(yefpkcig, yefmjever, yefmjmo, yefaldly))) %>%
  mutate(dep = washer(ymdeyr, 2, value = 0)) %>%
  mutate(religious = rowMeans(cbind(scale(yerlgsvc),
                                       scale(yerlgimp),
                                       scale(yerldcsn),
                                       scale(yefaiact)))) %>%
  mutate(parent = rowMeans(cbind(yeppkcig, yepmjever,

```

```
yepmjmo, yepaldly)))
```

*Models*

```

## Sampling Design
library(survey)
design = svydesign(ids = ~1,
                 strata = ~vestr,
                 weights = ~analwt_c,
                 data = d1)

## All a Path Models
## Unadjusted
svy_a1 = svyglm(self ~ religious, design = design)
svy_a2 = svyglm(peer ~ religious, design = design)
svy_a3 = svyglm(dep ~ religious, design = design,
               family = 'quasibinomial')

## Adjusted
svy_a12 = svyglm(self ~ religious + age2 +
                 irsex + newrace2 + irfamin3 + parent,
                 design = design)
svy_a22 = svyglm(peer ~ religious + age2 +
                 irsex + newrace2 + irfamin3 + parent,
                 design = design)
svy_a32 = svyglm(dep ~ religious + age2 +
                 irsex + newrace2 + irfamin3 + parent,
                 design = design,
                 family = 'quasibinomial')

## All b and c' Path Models (drink such low prevalence that it was not included)
svy_bc = svy_bc2 = list()
for (i in c("tobacco", "rx", "mari", "illicit")){

  ## Unadjusted Model
  model = as.formula(paste0(i, "~ self + peer + dep + religious"))
  svy_bc[[i]] = svyglm(model, design = design, family = "binomial")

  ## Adjusted Model
  model2 = as.formula(paste0(i, "~ self + peer + dep + religious + age2 +
                             irsex + newrace2 + irfamin3 + parent"))
  svy_bc2[[i]] = svyglm(model2, design = design, family = "binomial")

}

library(MarginalMediation)
## Tobacco
fit_tob = mma(svy_bc[["tobacco"]],
              svy_a1,

```

```
svy_a2,
svy_a3,
ind_effects = c("religious-self",
                "religious-peer",
                "religious-dep"),

boot = 500)
fit_tob2 = mma(svy_bc2[["tobacco"]],
              svy_a12,
              svy_a22,
              svy_a32,
              ind_effects = c("religious-self",
                              "religious-peer",
                              "religious-dep"),

              boot = 500)

## Rx
fit_rx = mma(svy_bc[["rx"]],
            svy_a1,
            svy_a2,
            svy_a3,
            ind_effects = c("religious-self",
                            "religious-peer",
                            "religious-dep"),

            boot = 500)
fit_rx2 = mma(svy_bc2[["rx"]],
             svy_a12,
             svy_a22,
             svy_a32,
             ind_effects = c("religious-self",
                             "religious-peer",
                             "religious-dep"),

             boot = 500)

## Marijuana
fit_mar = mma(svy_bc[["mari"]],
             svy_a1,
             svy_a2,
             svy_a3,
             ind_effects = c("religious-self",
                             "religious-peer",
                             "religious-dep"),

             boot = 500)
fit_mar2 = mma(svy_bc2[["mari"]],
              svy_a12,
              svy_a22,
              svy_a32,
              ind_effects = c("religious-self",
```

```

        "religious-peer",
        "religious-dep"),
    boot = 500)

## Illicit
fit_ill = mma(svy_bc[["illicit"]],
             svy_a1,
             svy_a2,
             svy_a3,
             ind_effects = c("religious-self",
                             "religious-peer",
                             "religious-dep"),
             boot = 500)
fit_ill2 = mma(svy_bc2[["illicit"]],
              svy_a12,
              svy_a22,
              svy_a32,
              ind_effects = c("religious-self",
                              "religious-peer",
                              "religious-dep"),
              boot = 500)

save(fit_tob, fit_tob2,
     fit_rx, fit_rx2,
     fit_mar, fit_mar2,
     fit_ill, fit_ill2,
     file = here("Data/NSDUH_2014_Results.rda"))

library(MarginalMediation)
library(tidyverse)
library(here)

load(file = here("Data/NSDUH_2014_Results.rda"))

## Extract direct effects
directs_fx = function(..., type){
  list(...) %>%
    map(~.x$dir_effects) %>%
    do.call("rbind", .) %>%
    data.frame(.) %>%
    select(Direct, Lower, Upper) %>%
    data.frame(., row.names =
                gsub("religious", "Religiousity (Direct)", row.names(.))) %>%
    rownames_to_column() %>%
    mutate(Outcome = c(rep("Tobacco", 1), rep("Prescription", 1),
                      rep("Marijuana", 1), rep("Illicit", 1))) %>%
    select(Outcome, rowname, Direct, Lower, Upper) %>%

```

```

set_names(c("Outcome", "Path", "Estimate", "Lower", "Upper")) %>%
mutate(CI = paste0("(", round(Lower,4), ", ", round(Upper,4), ")")) %>%
select(-CI) %>%
mutate(type = type)
}

directs_un = directs_fx(fit_tob,
                        fit_rx,
                        fit_mar,
                        fit_ill,
                        type = "Unadjusted")

directs_adj = directs_fx(fit_tob2,
                        fit_rx2,
                        fit_mar2,
                        fit_ill2,
                        type = "Adjusted")

## Extract indirect effects and bind to directs
inds_fx = function(..., type){
  list(...) %>%
  map(~.x$ind_effects) %>%
  do.call("rbind", .) %>%
  data.frame(.) %>%
  select(Indirect, Lower, Upper) %>%
  data.frame(., row.names = gsub("religious-", "Religiousity Through",
                                row.names(.))) %>%
  data.frame(., row.names = gsub("dep", "\nDepression",
                                row.names(.))) %>%
  data.frame(., row.names = gsub("self", "\nRespondent Views",
                                row.names(.))) %>%
  data.frame(., row.names = gsub("peer", "\nPeer Views",
                                row.names(.))) %>%

  rownames_to_column() %>%
  mutate(Outcome = c(rep("Tobacco", 3),
                     rep("Prescription", 3),
                     rep("Marijuana", 3),
                     rep("Illicit", 3))) %>%
  select(Outcome, rowname, Indirect, Lower, Upper) %>%
  set_names(c("Outcome", "Path", "Estimate",
             "Lower", "Upper")) %>%
  mutate(CI = paste0("(", round(Lower,4), ", ",
                               round(Upper,4), ")")) %>%
  select(-CI) %>%
  mutate(type = type)
}

unadjusted = inds_fx(fit_tob,
                    fit_rx,
                    fit_mar,
                    fit_ill,
                    type = "Unadjusted")

adjusted = inds_fx(fit_tob2,
                  fit_rx2,
                  fit_mar2,
                  fit_ill2,
                  type = "Adjusted")

```

```

        fit_ill,
        type = "Unadjusted") %>%
  rbind(directs_un)
adjusted = inds_fx(fit_tob2,
                  fit_rx2,
                  fit_mar2,
                  fit_ill2,
                  type = "Adjusted") %>%
  rbind(directs_adj)
inds = rbind(unadjusted, adjusted) %>%
  data.frame %>%
  mutate(type = factor(type,
                      levels = c("Unadjusted", "Adjusted"))) %>%
  mutate(Path = gsub("[0-9]", "", Path)) %>%
  mutate(Outcome = factor(Outcome,
                        levels = c("Tobacco", "Prescription",
                                   "Marijuana", "Illicit")))

## Odds ratios and linear effects as done in Ford and Hill
## Sampling Design
library(survey)
design = svydesign(ids = ~1,
                strata = ~vestr,
                weights = ~analwt_c,
                data = d1)

## All a Path Models
svy_a1 = svyglm(self ~ religious + age2 +
               irsex + newrace2 + irfamin3 + parent,
               design = design)
svy_a2 = svyglm(peer ~ religious + age2 +
               irsex + newrace2 + irfamin3 + parent,
               design = design)
svy_a3 = svyglm(dep ~ religious + age2 +
               irsex + newrace2 + irfamin3 + parent,
               design = design,
               family = 'quasibinomial')

## path a
patha_fx = function(obj, row){
  cbind(coef(obj)[row],
        confint(obj)[row,1],
        confint(obj)[row,2])
}
est1 =
  rbind(
    patha_fx(svy_a1, "religious"),

```

```

    patha_fx(svy_a2, "religious"),
    patha_fx(svy_a3, "religious")
  )
rownames(est1) = c("Respondent", "Peer", "Depression")
est1 = data.frame(est1) %>%
  set_names(c("Estimate", "Lower", "Upper"))

## All c and c' Path Models
svy_c = svy_c1 = list()
for (i in c("tobacco", "rx", "mari", "illicit")){

  model = as.formula(paste0(i, "~ religious + age2 +
                             irsex + newrace2 + irfamin3 + parent"))
  svy_c[[i]] = svyglm(model, design = design, family = "quasibinomial")

  model2 = as.formula(paste0(i, "~ self + peer + dep + religious + age2 +
                              irsex + newrace2 + irfamin3 + parent"))
  svy_c1[[i]] = svyglm(model2, design = design, family = "quasibinomial")
}

## Odds ratios of c and c' path models
pathc_fx = function(obj, row, drug){
  cbind(coef(obj[[drug]])[row],
        confint(obj[[drug]])[row,1],
        confint(obj[[drug]])[row,2])
}

est2 =
  rbind(
    cbind(pathc_fx(svy_c, "religious", "tobacco"),
          pathc_fx(svy_c1, "religious", "tobacco")),
    cbind(pathc_fx(svy_c, "religious", "rx"),
          pathc_fx(svy_c1, "religious", "rx")),
    cbind(pathc_fx(svy_c, "religious", "mari"),
          pathc_fx(svy_c1, "religious", "mari")),
    cbind(pathc_fx(svy_c, "religious", "illicit"),
          pathc_fx(svy_c1, "religious", "illicit"))
  )
rownames(est2) = c("Tobacco", "Rx",
                  "Marijuana", "Illicit")
est2 = data.frame(est2) %>%
  set_names(c("c", "c_Lower", "c_Upper", "c1", "c1_Lower", "c1_Upper"))

```



*Tables and Figures*

Table ?? on page ??

```
## overall table1 (not adjusted for survey weights)
d1 %>%
  table1(factor(rx), factor(tobacco),
          factor(drink), factor(mari), factor(illicit),
          irsex, factor(iffelse(newrace2 == "(1) NonHisp White", 0, 1)),
          factor(
            iffelse(poverty2 == "(3) Income > 2X Fed Pov Thresh (See comment above)",
                    1, 0)),
          factor(dep), self, peer, parent, religious,
          type = c("simple", "condense"),
          var_names = c("Prescription", "Tobacco",
                        "Heavy Drinking", "Marijuana",
                        "Other Illicit", "Sex",
                        "Race (Non-White)",
                        "Income (2x poverty)",
                        "Major Depression Episode",
                        "Respondent", "Peer",
                        "Parent", "Religiosity"),
          output = "latex2")

## Survey weighted
library(survey)
design = svydesign(ids = ~1,
                 strata = ~vestr,
                 weights = ~analwt_c,
                 data = d1)

svymean(~rx, design)
svymean(~tobacco, design)
svymean(~drink, design)
svymean(~mari, design)
svymean(~illicit, design)
svymean(~irsex, design)
svymean(~newrace2, design)
svymean(~poverty2, design)
svymean(~dep, design, na.rm=TRUE)
svymean(~self, design, na.rm=TRUE)
svymean(~peer, design, na.rm=TRUE)
svymean(~parent, design, na.rm=TRUE)
svymean(~religious, design, na.rm=TRUE)

## alpha of religiosity
with(d1,
      psych::alpha(cbind(scale(yerlgsvc),
                          scale(yerlgimp),
```

```

        scale(yerldcsn),
        scale(yefaiact))))

## alpha of respondent
with(d1,
  psych::alpha(cbind(yegpkcig, yegmjevr,
                    yegmjmo, yegaldly)))

## alpha of peer
with(d1,
  psych::alpha(cbind(yefpkcig, yefmjevr,
                    yefmjmo, yefaldly)))

## alpha of parent
with(d1,
  psych::alpha(cbind(yeppkcig, yepmjevr,
                    yepmjmo, yepaldly)))

## number of heavy drinking responses
sum(d1$drink)

```

Table ?? on page ??

```

perc_fx = function(obj){
  obj$ind_effects[,3]/(obj$dir_effects[,1] +
    sum(obj$ind_effects[,3]))
}

percent_ind = cbind(perc_fx(fit_tob2),
  perc_fx(fit_rx2),
  perc_fx(fit_mar2),
  perc_fx(fit_ill2)) %>%

data.frame %>%
set_names(c("Tobacco", "Prescription", "Marijuana", "Illicit")) %>%
map_df(~.x*100) %>%
mutate(Mediator = c("Respondent Views", "Peer Views", "Depression")) %>%
select(Mediator, Tobacco, Prescription, Marijuana, Illicit)

percent_ind = percent_ind %>%
rbind(data.frame(
  Mediator = "Total",
  Tobacco = sum(percent_ind$Tobacco),
  Prescription = sum(percent_ind$Prescription),
  Marijuana = sum(percent_ind$Marijuana),
  Illicit = sum(percent_ind$Illicit)
))

library(xtable)
xtable(percent_ind, digits = 1)

```

Table ?? on page ??

```
est21 = est2 %>%
  rownames_to_column() %>%
  group_by(rowname) %>%
  summarize(perc = ((c - c1)/c)*100)
library(xtable)
xtable(est21, digits = 1) %>%
  print.xtable(include.rownames = FALSE)
```

Figure ?? on page ??

```
p = position_dodge(width = .2)
inds %>%
  filter(type == "Adjusted") %>%
  ggplot(aes(Path, Estimate, group = type, color = type)) +
    geom_hline(yintercept = 0, color = "darkgrey") +
    geom_point(position = p, alpha = .8) +
    geom_errorbar(aes(ymin = Lower, ymax = Upper),
                  position = p, alpha = .8,
                  width = .3) +
  facet_wrap(~Outcome) +
  coord_flip() +
  anteo::theme_anteo_wh() +
  theme(legend.position = "bottom",
        axis.line = element_line(color = "darkgrey"),
        panel.spacing = unit(.3, "in")) +
  scale_color_manual(values = c("chartreuse4", "coral2"),
                     guide = FALSE) +
  labs(x = "", y = "",
       color = "")
```

## CURRICULUM VITA