

Use of Judgment in the Projection Process: Examiner Perspective

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What are some areas where expert judgment is used in the projection process?

- Estimation or projection methodologies without a statistical model
- Overlays or adjustments
- Model development
 - Choice of data set
 - Choice of modeling approach
 - Choice of factors
- Focus on the first two areas

What are some potential examination concerns that may arise regarding the use of judgement?

- Root cause
 - What is the issue that the overlay is adjusting for; does the company know what the root cause is and what the size of it is; what are the plans to “squeeze out” the judgment, if possible?
 - Is the overlay expected to be a short term or a long term “fix”?
 - Is the use of expert judgment due to the lack of sufficient resources devoted to the projection? Is the projection even feasible if there were more resources?
 - If judgment is used, is there a breakdown in a line of defense (developer, validation, audit)? Is there a breakdown in the model or data?
 - Is the overlay so excessive that it suggests the process is broken? Should a different approach be taken?

What are some potential examination concerns that may arise regarding the use of judgement?

- **Materiality**
 - Is the area where judgment is used material?
- **Awareness**
 - Is management aware of the issue; do they see the results with and without the judgment?
 - Is the judgment conservative; is an overlay being applied for the sake of being conservative; can the underlying problem be fixed?

Statistical model concerns are also likely judgmental “model” concerns

- Correlation with macro-factors (i.e., scenarios provided by regulators)
 - Ability to forecast baseline with the inclusion of macro-factors
- Empirical support
- Appropriate segmentation
- Sensitivity testing – how do the results differ if you change a particular assumption?
- Performance monitoring
 - Comparison to historical losses
 - Back-testing
 - Out-of-sample performance testing

Statistical model concerns are also likely judgmental “model” concerns (continued)

- Data relevancy
- Governance/validation
 - Clarity on approval process and any limited approval process
 - Supporting policies and procedures that govern use of judgment – that includes guard rails and consistency checks
 - Repeatable and transparent
- Understanding of why judgmental process is appropriate and “necessary”

It may be more difficult to support judgmental “estimation” approaches when ...

- Portfolio or line item has significant size
- Portfolio or line item has significant risk
- Judgment is the sole projection framework for entire areas
- Portfolio or line item is anticipated to grow; area of strategic growth

It may be less difficult to support a judgmental “estimation” approach when ...

- Risk is immaterial or less material
- Use is limited or scoped to a particular area where there is a model weakness
- Portfolio is in run off
- Data are not available
- Judgmental estimation produces a more accurate, sensitive and credible results with sufficient supporting rigor
- Modeling alternative is overly complicated, “black-box” and tentative