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Proposal: 1438 (RIN 7100-AD86) - Reg. YY Enhanced Prudential Standards and Early Remediation for Covere
Subject: Reg. YY

Comments:

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Proposal: Regulation YY - Enhanced Prudential Standards and Early Remediation Requirement for Covered Companies
Requirement for Covered Companies
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Comments:

The proposal is all about process so that the OCC, FDIC, and FRB can't be held accountable if the process fails or the existence of a control. This is a failure on the part of the OCC, FDIC, and FRB because they do not establish specific criteria for the effectiveness of the controls. The Failure of Risk Management takes a close look at misused and misapplied basic analysis methods and shows how some of the most popular "risk management" methods are no better than astrology! Using examples from the 2008 credit crisis, natural disasters, outsourcing to China, engineering disasters, and more, Hubbard reveals critical flaws in risk management methods-and shows how all of these problems can be fixed. The solutions involve combinations of scientifically proven and frequently used methods from nuclear power, exploratory oil, and other areas of business and government. As noted by Hubbard, the Guidance needs to overcome that the standard problems with experience which are: (a) people experience nonrandom, nonscientific samples of events in their life time, (b) it is memory based and people are selective on what they remember, (c) peoples conclusions can be full of errors, (d) unless people have feedback on past decisions there is no reason to believe their experiences tell us much. <http://howtofixriskmgt.com/> On pages 250 - 254, Hubbard discusses providing incentives for "A Calibrated Culture" where the incentives push people to make more accurate forecasts. Recommendation 1. Disallow any stress testing model which uses methods no better than astrology including numerical weighting schemes such as the CAMELS rating. Recommendation 2. At the minimum, specifically identify the disallowed stress testing methods. Recommendation 3. At a minimum, firms should calculate the Briers score for each forecast and stress test and keep the scores for multiple years to determine whether there is any trend in forecast and stress test accuracy. On pages 227 - 233, Hubbard discusses using Bayes Theorem when you have few data points to calculate risk. Recommendation 4. Use Bayes Theorem to calculate the probability of a good stress test given a good risk/stress model. It is the somewhat gratifying lesson of Philip Tetlock's new book, "Expert Political Judgment: How Good Is It? How Can We Know?" (Princeton; \$35), that people who make prediction their business-people who appear as experts on television, get quoted in newspaper articles, advise governments and businesses, and participate in punditry roundtables-are no better than the rest of us. When they're wrong, they're

rarely held accountable, and they rarely admit it, either. They insist that they were just off on timing, or blindsided by an improbable event, or almost right, or wrong for the right reasons. They have the same repertoire of self-justifications that everyone has, and are no more inclined than anyone else to revise their beliefs about the way the world works, or ought to work, just because they made a mistake. No one is paying you for your gratuitous opinions about other people, but the experts are being paid, and Tetlock claims that the better known and more frequently quoted they are, the less reliable their guesses about the future are likely to be. The accuracy of an expert's predictions actually has an inverse relationship to his or her self-confidence, renown, and, beyond a certain point, depth of knowledge. People who follow current events by reading the papers and newsmagazines regularly can guess what is likely to happen about as accurately as the specialists whom the papers quote. Our system of expertise is completely inside out: it rewards bad judgments over good ones. http://www.newyorker.com/archive/2005/12/05/051205crbo_books1

Tetlock has already developed a framework and documented a framework for evaluating predictions. His framework looks at the question is a variable expected to go up or down? Did the expert accurately predict the direction of change. Further, even if the expert correctly predicted the direction of change, then how close were they in predicting the magnitude of change?

Recommendation 5. Implement Tetlock's framework to track forecast and stress testing accuracy over multiple years. Recommendation 6. Establish numerical thresholds for disallowing stress testing models / risk management practices when the level of accuracy is too low based on Tetlock's framework.