CASE STUDY

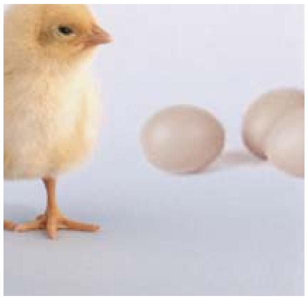
OPERATIONAL RISK

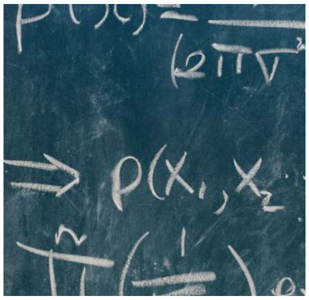
Prudential adds an external loss database to its framework of managing operational risk.

Algorithmics

Prudential Financial, one of the most respected financial services companies in the U.S., is also a leading-edge firm when it comes to managing operational risk. At a time when the insurance industry is just starting to address the discipline, Prudential has a mature program in place based upon four disciplines: risk and control self-assessment, key risk indicators, analysis of internal losses, and issue tracking and management reporting.

Prudential, which already had a robust centralized response to operational risk management in place, embarked upon an initiative to push its operational risk best practices out to the business units within the organization. In so doing, managers in each business area were now required to accept ownership and direct accountability for the operational risk in their departments. In order to equip managers with the tools and oversight they needed to succeed, a newly established operational risk management committee set about the task of developing a comprehensive risk framework. As part of this process, Prudential decided it needed to complement its internal loss repository with an external loss database that was consistent with Prudential's own qualitative and management-oriented approach. To do this, Prudential turned to the Algo FIRST database of case studies.





Headquartered in Newark, New Jersey, Prudential Financial provides a range of financial products and services, including life insurance, mutual funds, annuities, pension and retirement related services and administration, asset management, securities brokerage, banking and trust services, real estate brokerage franchises and relocation services. Founded in 1875 to provide life insurance to working families, the company has expanded to become a major US and global financial organization.

"As Prudential prepared to become a public company in 2001, the management team wanted to stress the company's philosophy based on the principle that accountability for internal control and risk management rests with management within the business units of the corporation, instead of with the internal audit and compliance department," says Mario Mosse, vice president of corporate risk management at Prudential. "That created a renewed focus on proactive risk management."

This new approach to risk included the adoption of a series of practices that would focus on managing risk, avoiding unanticipated losses, reducing volatility, and enhancing shareholder value; the key component of the program was to manage risk at the business line level. In order to develop the standards, processes, tools and oversight that would be required by each department, the firm developed an internal control organization in the spirit of approaching risk from a "best-practice" perspective.

Once the operational risk management organization was formed, the corporate operational risk management group embarked upon identifying industry best practices and, based on its research findings, decided to model Prudential's operational risk program after the operational risk approach practiced by trend-setting banks that were responding to capital and safety and soundness regulations coming out of the Bank of International Settlements. Prudential took what it referred to as the 'Basel approach', or the 'banking model', and adapted it to the insurance arena. Prudential decided that its focus would be on managing risk, avoiding losses, reducing volatility, and ultimately enhancing shareholder value.

Prudential then worked to define a framework that shared a common language and methodology, and that implemented risk modules gradually within the organization. It began with what it already had in place and worked to enhance its existing risk and control self-assessment (RCSA) practice. Prudential's goal was to institutionalize

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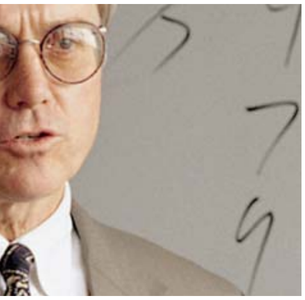
and standardize the RCSA process to make it consistent across various business units. Because Prudential already used consistent language, such as risk and control definitions, to aggregate data and establish benchmarks, it was already on its way to successfully implementing its business unit-focused approach.

The second component the corporate group focused on was the development of key risk indicators; this was something that every business was already tracking informally and Prudential was able to standardize the process by developing a common approach.

Next, the corporate group moved into the analysis of loss event data, a fundamental component of its operational risk framework. "By looking at our own internal loss events we could ask what was the possibility of the loss events happening again in the future?" says Peter Trost, vice president of corporate operational risk management at Prudential. "And we were able to examine if a loss event happened in one particular business area, if there were root causes associated with the event that could contribute to its reoccurrence in other areas of the business."

The corporate group embarked on a search for an external loss event tool that would complement its existing internal loss event analysis database. The external loss database had to be consistent with Prudential's qualitative, management-oriented approach if it was going to add value to the process, and not just act as a repository of raw data that could be placed into a model. Prudential also wanted to be able to compare its control environment with that of firms that had already experienced losses. The corporate group wanted to look at trends, anticipate issues, and perform internal reviews to determine if it could experience the same problems that were being encountered in other organizations. Hence, a tool was needed that would not only provide information about external losses but could be used to do root cause analysis in order to learn from the experiences of others.

It was the Algo FIRST database of case studies that met Prudential's requirements for external loss data. Algo FIRST provides a centralized resource for operational risk managers containing over 7,500 case studies of loss events. "The depth and breadth of the database impressed us and met our requirements for external loss data that would complement our internal loss information," says Trost.

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Initially, Trost's corporate risk group took a subscription to Algo FIRST, which allowed Trost and his colleagues to access the database online, as well as to receive Algo FIRST's regular newsletter, which highlights and analyzes recent loss events. Trost's corporate risk group used Algorithmics' Algo FIRST Newsletter, as well as an internal newsletter that they produced themselves, to share information and raise awareness among the different lines of business. "We based our internal newsletter either on something in the Algo FIRST Newsletter, or on a case study of interest we discovered ourselves by going into the database. We would elaborate on the case study and how it might apply to Prudential and put it in our newsletter," says Trost.

Trost and his colleagues also looked for trends, as revealed by the database, related to areas of relevance to Prudential's business. Specifically, they looked at areas where Prudential may have had losses, and compared the company's performance with that of its peers. The cases, as well as any other relevant articles or information, were then disseminated to the business line risk officers.

Having established the value of the case studies, Prudential then discussed how it could better share the information from Algo FIRST, and how it could improve its use by the various business lines. The company decided to roll out access to the database to all risk officers and their staff. Thus, while Trost and his colleagues continued to produce their internal newsletter to draw the attention of risk officers to the information available in Algo FIRST, the same risk officers and their teams could now also query and search the database for cases relevant to issues and projects in their area of activity.

Using keywords, product or competitor names, country or other search criteria, risk managers can search the database for information relevant to their current projects. Because Prudential is a complex organization and covers so many business areas, it has many competitors – relatively few at the group level, but many in each line of business. The database enables risk managers to identify competitors, and the loss events in their area of interest, and discover what they can learn from them – all using a centralized resource. "We are very proud of what's becoming a more mature operational risk program," says Mario Mosse.

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About Algorithmics

Algorithmics is the world's leading provider of enterprise risk solutions. Financial organizations from around the world use Algorithmics' software, analytics and advisory services to help them make risk-aware business decisions, maximize shareholder value, and meet regulatory requirements. Supported by a global team of risk experts based in all major financial centers, Algorithmics offers proven, award-winning solutions for market, credit and operational risk, as well as collateral and capital management. Algorithmics is a member of the Fitch Group.

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