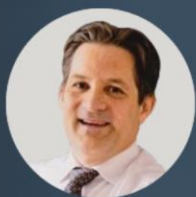


Panel discussion on

Changing Model Risk Management expectations in Europe and the UK

Key Findings

Eminent Panelists



Peter Nowlan
Head of Model Risk
RBS



Maz GBM Khan
Head of Wholesale Risk Analytics
HSBC



Slava Obratsov
Global Head of Model Validation
Nomura



Evgueni Ivantsov
Chairman of the European
Risk Management Council

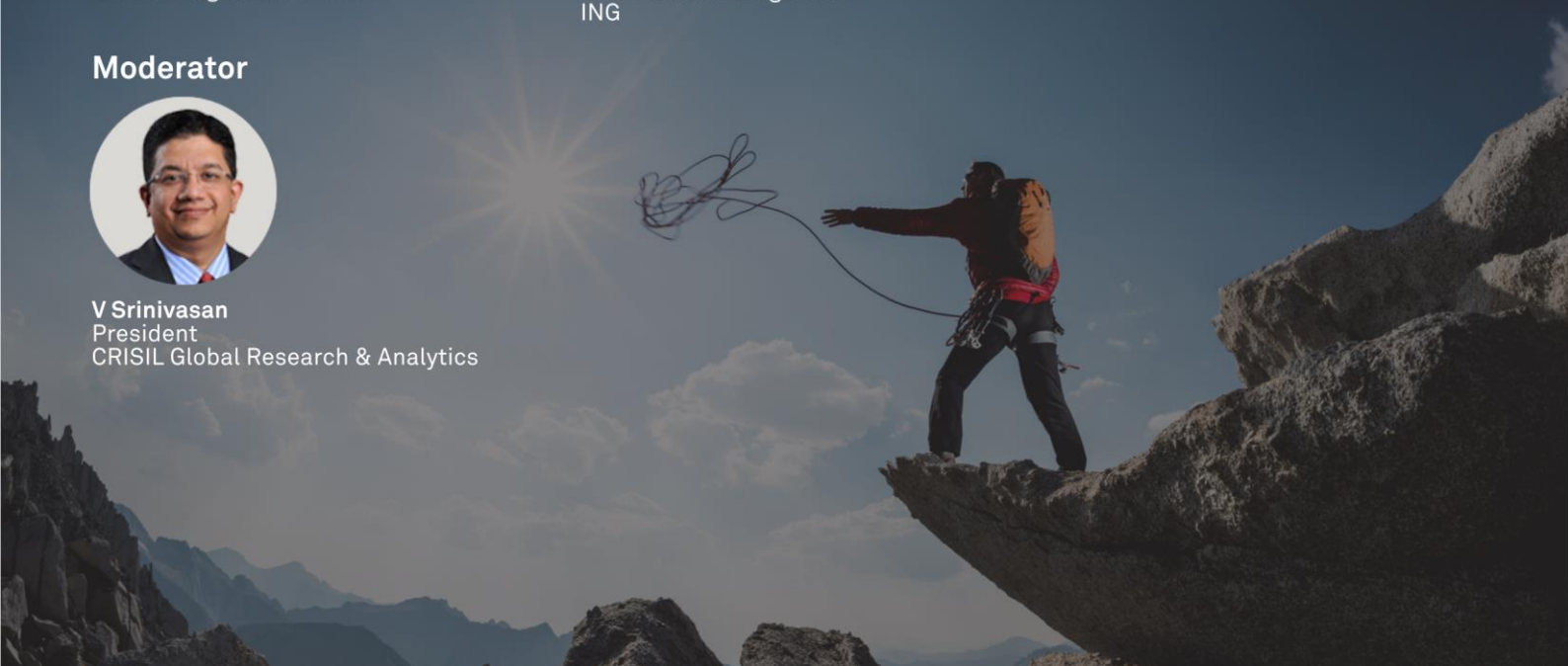


Diederik Fokkema
Financial Risk Officer –
Model Risk Management
ING

Moderator



V Srinivasan
President
CRISIL Global Research & Analytics



CRISIL GR&A panel discussion summary

MRM expectations are changing in Europe and the UK

The Model Risk Management (MRM) landscape in Europe and the UK has started changing following recent regulatory measures in the region, such as the Targeted Review of Internal Models (TRIM) of the European Central Bank (ECB), the new Definition of Default (DoD) of the European Banking Authority (EBA) and the supervisory statement (SS) 3/18 of the Prudential Regulation Authority (PRA).

To help MRM practitioners in the region gauge the import of these changes, CRISIL GR&A hosted a panel discussion on '*Changing MRM expectations in Europe and the UK*' in London on January 24, 2019.

The panel comprised Peter Nowlan, Head of Model Risk, RBS; Maz Khan, Head of Wholesale Risk Analytics, HSBC; Slava Obratsov, Global Head of Model Validation, Nomura; Dr Evgueni Ivantsov, Chairman of the European Risk Management Council; and Diederik Fokkema, Financial Risk Officer - MRM, ING.

V Srinivasan, President - CRISIL GR&A, moderated the discussion.

The audience comprised over 45 delegates, including existing and prospective clients from investment banks and commercial banks in Europe and the UK.

Four near-term focus areas

The panellists agreed that the regulatory initiatives will raise the existing MRM standards and ensure consistency in their use across EU/UK banks.

The regulations have established the need for: (1) having a common default definition, (2) establishing comprehensive MRM policies & procedures, (3) improving data quality & building model inventory, and (4) achieving independence between the first and second lines of defence.

These are marked as focus areas for the next 1-2 years.

Looking at all models as assets

The panellists believed addressing these areas will sharpen focus on process alignment for effective MRM – in terms of generating active ownership of model risk by banks – where a deeper understanding of model limitations and uncertainties by model users will impact their decision making on real time basis.

Currently, due to lack of focus on exercises to educate model users on model risk, there is a lack of clarity of model risk ownership. MRM, for the most part, is still a reactive and detective function, rather than an active and preventive function.

One of the panellists cited a culture issue where a good model (appropriately validated) was not used despite being available because the user was not comfortable with it.

In light of this, the bank's senior management is putting in place measures that ensure everybody across its three lines of defence treats every model as an asset. This requires enhanced understanding of the benefits of model use and of the importance of maintaining and monitoring them.

On a separate note, the panellists also indicated that the regulators should address formally the role of MRM in this new Digitalisation Age.

The evolution of model risk appetite

The panellists agreed that model risk appetite is a relatively new concept and has not evolved completely given that characterising model risk comprehensively is difficult as this risk can be attributed to multiple sources.

The panellists also agreed that there is no industry standard for model risk appetite framework today. They acknowledged that measuring model risk for pricing/ valuation models is easier than for regulatory capital/ compliance models. This is because one size does not fit all and some quantitative metrics would need to be augmented by softer metrics related to model development and validation processes, whose direct impact in terms of financial loss is difficult to measure.

The best MRM approach

It was also discussed that an analytical MRM approach may not be appropriate to quantify model risk at times, and that an operational-risk style of scenario-based approach should be undertaken to quantify the financial impact of model risk.

Lines of defence and governance challenges

Regarding model governance challenges related to modelling/data updates led by EBA's regulatory products of New Default Definition and Materiality Thresholds, the panellists indicated they are running big programmes as part of their book of work to address these requirements.

The first line of defence acknowledges that since current systems are quite fragmented across entities and exposure types, achieving harmonisation of new default definition across systems is quite a challenge. More time and money is getting invested to address this issue from bottom up.

From second line of defence, rather than sit back for a handover, the model validators are actively integrating with first line of defence (while maintaining independence) on an ongoing basis. The aim is to identify their needs for justification (of subject matter expertise-based judgements) wherever applicable, in order to prevent any unnecessary iteration.

The data and methodology updates question

The panellists also agreed that while banks in many instances have made the necessary data and methodology updates, there is uncertainty on whether these updates would be acceptable to the regulators or whether more remediation is required.

TRIM inspections have lent a hand

On TRIM inspections, the panellists indicated that these inspections are very intrusive and forward-looking and there are gaps even in the new guidelines. That said, these inspections do create model risk awareness among model developers, model validators and model users on issues of data, methodology and governance. The panellists also acknowledged that the inspections have helped make MRM more

agile as representatives across IT, model development, model validation and model use come together to prepare for these.

On LDP and SS3/18

The panellists indicated that upcoming inspections of low default portfolio (LDP) throw up a number of findings as LDP business is managed by both professionals and the model. As such, model outputs are more prone to overrides and overlays, and the process behind them may not be as transparent as one would wish for.

The panellists welcomed the SS3/18 regulatory guideline as it is applicable to stress testing models, which have a lot of inherent uncertainty (due to lack of data) as these try to estimate the tail risk. Besides, with this, modelling of non-financial risk related to geo-political events and cyber security threats would gain prominence.

The regulations are expected to formally drive all the three lines of defence to do deeper evaluation and documentation of model uncertainties, benchmarks and use of judgement/ overlays.

Machine Learning and automation usage

On the use of Machine Learning (ML)/automation in MRM, the panellists agreed that automation reduces the production time for a given model. However, they expressed concern on using ML algorithms blindly. Driven by their black-box approach, some contended the use of ML may require continuous monitoring of any potential bias leading up to the model output.

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