



Executive Summary, 2022-SR-B-016, December 7, 2022

## The Board Can Enhance the Effectiveness of Certain Aspects of Its Model Risk Management Processes for the SR/HC-SABR and BETR Models

### Findings

The Division of Supervision and Regulation (S&R) uses supervisory models, such as the Supervision and Regulation Statistical Assessment of Bank Risk (SR-SABR), Holding Company Statistical Assessment of Bank Risk (HC-SABR) (together, SR/HC-SABR), and Bank Exams Tailored to Risk (BETR) models, to advance risk-focused supervision of financial institutions. Supervisory model results help to inform decisions regarding supervisory programs and initiatives, the supervision of individual institutions, and the allocation of staff resources; therefore, it is important to ensure that the models S&R uses are sound and produce reasonable and reliable outputs.

Although S&R has taken steps to enhance model risk management for the SR/HC-SABR and BETR models, we found opportunities for S&R to further enhance certain aspects of its model risk management processes. Specifically, S&R can ensure timely review and validation of the SR/HC-SABR and BETR models. Many of the SR/HC-SABR and BETR models in use have not undergone Committee on Supervisory Model Oversight (COSMO) review and System Model Validation (SMV) group validation, in part because of COSMO's resource constraints. In addition, S&R can enhance model risk management by developing a comprehensive model inventory of top-tier supervisory models (TTSMs), including the SR/HC-SABR and BETR models, that aligns with the guidance outlined in Supervision and Regulation Letter 11-7: *Supervisory Guidance on Model Risk Management* (SR Letter 11-7). Further, S&R can benefit from developing a formal mechanism for tracking the findings and recommendations from COSMO reviews and SMV validations. A formal mechanism could help COSMO manage model risk and promote effective remediation of findings and recommendations.

### Recommendations

Our report contains recommendations designed to enhance the effectiveness of the Board's model risk management processes for the SR/HC-SABR and BETR models. In its response to our draft report, the Board concurs with our recommendations and outlines actions that will be taken to address each recommendation. We will follow up to ensure that the recommendations are fully addressed.

### Purpose

We conducted this evaluation to assess the effectiveness of the model risk management processes for the SR/HC-SABR and BETR models. This evaluation addressed governance and model validation activities for the SR/HC-SABR and BETR models for 2020 and 2021. Our scope did not include aspects of the model risk management framework related to model development.

### Background

The use of models invariably presents *model risk*—the risk that decisionmaking may be influenced by incorrect or misapplied model outputs or reports. Because using models involves model risk, the Board issued SR Letter 11-7 to establish model risk management expectations for supervised institutions. SR Letter 11-7 includes expectations for (1) development, implementation, and use; (2) validation; and (3) governance, policies, and controls.

COSMO is an oversight body for TTSMs, including the SR/HC-SABR and BETR models, and conducts model review of TTSMs. After COSMO completes its review, the SMV group independently validates the TTSMs. COSMO's charter states that COSMO and its associated processes align, to the extent possible and appropriate, with the principles of sound model risk management practices articulated in SR Letter 11-7.