



## Newsletter Article

April / May, 2016

### MODEL RISK MANAGEMENT: YOUR RESPONSIBILITIES

By Sterling Compliance LLC (originally published in Sterling Navigator, May 2016. Reprinted with permission)

#### ABOUT THE AUTHOR

**Sterling Compliance LLC** was forged out of a strong bond of integrity, shared vision and unwavering commitment to excellence in compliance consulting. With nearly 40 years of combined experience managing and regulating financial institutions, Sterling's mission is to be an integral, independent resource to your compliance management team.

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Banks are relying more heavily on quantitative analysis and models in financial decision-making. Banks have applied models to more complex products and with more ambitious scope, such as enterprise-wide risk measurement, while the markets in which they are used have also broadened and changed<sup>1</sup>.

#### MODEL RISK

The potential for adverse consequences from decisions based on incorrect or misused model outputs and reports. Model risk can lead to financial loss, poor business and strategic decision making or damage to a bank's reputation.

Whether you have a model designed to assess your levels of interest rate risk and the impact to your current and projected performance or you have a platform for BSA compliance, models come with costs: implementation costs, support costs and the resulting validation and testing costs.

In April 2011, the OCC published [guidance](#) that addressed sound model risk management practices. However, the concepts can be applied to any financial institution that utilizes models to measure and assess the risks and impact of doing business and are relevant today more than ever.

Model risk management begins with robust model development, implementation and use. Another essential element, as noted above, is a sound model validation process. Governance – a theme in this month's Navigator – sets an effective framework with defined roles and responsibilities for clear communication of model limitations and assumptions as well as the authority to restrict model usage.

The graphic on the following page outlines model risk management infrastructure from the purpose and scope of the program, Board oversight and management responsibilities to model development and implementation, followed by validation and back-end testing processes.

Coming to BankersHub



**Surfing Through the Storm of Flood Insurance**  
From Traditional Requirements to Emerging Compliance Issues

Webinar: May 24, 2016  
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Speaker  
Angela Lucas  
Managing Partner and Co-Founder  
Sterling Compliance LLC




Flood compliance requirements, impacts of legislation and effective testing mechanisms for managing your Flood Compliance Function



**HMDA**  
Complying with Today's Rules and Expanded Data Collection

Webinar: May 26, 2016  
12:00 – 1:30 pm ET

Speaker  
Lisa Zigo  
Managing Partner and Co-Founder  
Sterling Compliance LLC



Gaining a firm understanding of HMDA and complex issues that trip up banks and credit unions, as well as benefiting from new data collection rules

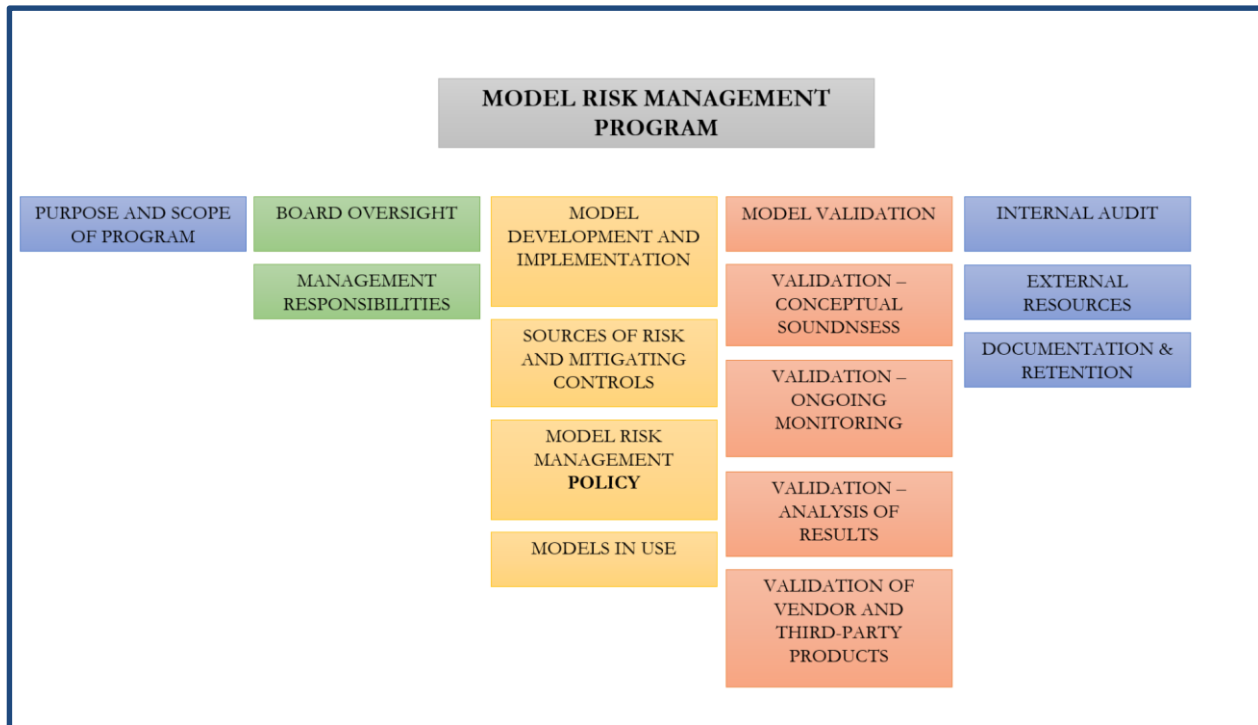
#### ABOUT BankersHub

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Let's relate this to a model that is likely within your purview: Automated BSA monitoring platforms. Many banks have been looking to implement automated programs to do the "heavy lifting" – to monitor the customer base on an ongoing basis and provide alerts of atypical and unusual activity according to established parameters. While these platforms can provide significant efficiency to the monitoring process, it is critical that you establish an appropriate infrastructure to support the program and ensure the integrity of information generated. Model risk management begins at the top – with the Board and Senior Management – but it is critical that BSA and Compliance personnel are part of the planning, implementation, validation and testing processes. Getting the infrastructure in place is the first step. Once an effective infrastructure is established, implementation and validation should go rather smoothly. In setting the stage on the front end, you know the cost and general flow of the implementation process. You will also have estimated the cost of support and validation and built them into your budget. That's not to say there won't be bumps in the road – there will be – but part of establishing your model risk management program is anticipating those bumps.

If you are in the beginning stages of researching and planning for an automated BSA platform, following the process outlined above should help you through the process. If you have a system in place, use this guidance as a reference point against which you can compare your bank's model risk management program. We have included a **Model Risk Management Checklist** on the next page to help you through assessing the adequacy of your program.



## MODEL RISK MANAGEMENT POLICY CHECKLIST

<input type="checkbox"/>	Model and Model Risk Definitions
<input type="checkbox"/>	<p>Roles and Responsibilities</p> <ul style="list-style-type: none"> <li>▪ Staff Expertise</li> <li>▪ Authority</li> <li>▪ Reporting Lines</li> <li>▪ Continuity</li> </ul>
<input type="checkbox"/>	Usage of External Resources for Validation and Compliance
<input type="checkbox"/>	<p>Assessment of Model Risk</p> <ul style="list-style-type: none"> <li>▪ Sources of risk and mitigating controls</li> <li>▪ Limits on model use</li> <li>▪ Monitoring model performance</li> <li>▪ Adjusting or revising models over time</li> <li>▪ Supplementing model results with other analysis and information</li> </ul>
<input type="checkbox"/>	<p>Acceptable Practices for Model Development, Implementation and Use</p> <ul style="list-style-type: none"> <li>▪ Processes Used to Select and Retain Vendor Models, including those who should be involved in such decisions</li> </ul>
<input type="checkbox"/>	Model Inventory (those in use)
<input type="checkbox"/>	<p>Appropriate Model Validation Activities</p> <ul style="list-style-type: none"> <li>▪ Prioritization, Scope and Frequency of Validation Activities</li> <li>▪ Testing and Analysis</li> <li>▪ Standards for the Extent of Validation (to be performed <i>before</i> models are implemented)</li> <li>▪ Scope of Ongoing Validation</li> <li>▪ Targets for Model Accuracy</li> <li>▪ Standards for Acceptable Levels of Discrepancies</li> <li>▪ Procedures for Review and Response to Unacceptable Discrepancies</li> </ul> <p>Note: You may have to address each of the above items model by model as the information is likely to vary based on the model's intent and usage</p>
<input type="checkbox"/>	Results of Modeling and Valuation Processes
<input type="checkbox"/>	Model Issues and Respective Resolutions
<input type="checkbox"/>	Governance and Controls Over the Model Risk Management Process (i.e. Responsibilities of Senior Management and the Board, oversight, etc.)
<input type="checkbox"/>	Reporting (i.e. frequency and content of reports regarding the status of the model risk management program and underlying modeling activities)
<input type="checkbox"/>	Retention of Data (including tracking of changes to assumptions and parameters as well as documentation of testing and validation activities)

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Presenter: Cindy Orozco, AAP NCP



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**Creating A Culture to Combat Money Laundering**

**May 11 - 13, 2016**  
12:00 – 1:00 pm ET



**3 Webinars for Banks & Credit Unions**  
Presenter: Dennis Lormel  
*Founder and President – DML Associates  
Former FBI Agent and Advisor – Congressional Anti-Terrorist Financing Task Force*



**WEBINAR**  
**Branch Manager's Guide to Customer Satisfaction**



**June 24, 2016**  
**12:00 – 1:00 pm ET**

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**ANTI-MONEY LAUNDERING AND COMPLIANCE 2016**

