Model Risk Management at U.S. Operations of Foreign Banking Organizations

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This Ask the Fed® session provided a summary of application of *Supervisory Guidance on Model Risk Management* (SR Letter 11-7) to U.S. operations of foreign banking organizations (FBOs), including for U.S. branches and agencies. The session also outlined the supervisory expectations in the guidance and discussed some specific issues that may arise when conducting model risk management (MRM) for U.S. operations within a broader FBO structure.

Purpose/Background of SR 11-7

In 2011, the Federal Reserve and the Office of the Comptroller of the Currency (OCC) issued the model risk management guidance (MRMG) through SR 11-7 and Bulletin 2011-12[1]. The guidance focuses on all aspects of MRM with model validation at the core, and outlines a "framework" for banks and supervisors to evaluate MRM.

Under SR 11-7, MRMG applies to "bank holding companies (BHCs), state member banks, and all other institutions for which the Federal Reserve Board is the primary supervisor". Materiality plays a very important role in applicability as the burden is lower on entities with fewer or less sophisticated models. All U.S. operations of FBOs are included, with U.S. BHC subsidiaries of FBOs generally assessed along with domestic U.S. BHCs.

Overview

MRM should be applied similar to other risk management techniques where the source of risk is identified and where materiality plays an important role. Model risk cannot be eliminated, so it must be managed. A key principle of MRM is effective challenge, in which critical, unbiased parties evaluate models and their application to identify model limitations and assumptions, and to produce appropriate changes. MRM will only be successful with strong involvement of board and senior management oversight. It is important to emphasize the key roles and responsibilities of participants in all MRM activities. Documentation and transparency are key and required for credible validation and proper usage. The session also discussed good practices and ongoing challenges identified by supervisors in all areas of MRM.

MRM at U.S. Operations of FBOs

Supervisors recognize that applying SR 11-7 to the U.S. operations of FBOs presents certain issues and challenges. Some models are developed and validated in the home country, and this practice may be acceptable as long as the firm has demonstrated that the validation is both applicable to the U.S. operations and adequately meets SR 11-7 standards. SR Letter 11-7 is NOT intended to apply expectations to the FBO parent. However, models used at U.S. operations should conform to the MRMG. Finally, it is reasonable for MRM to be conducted similarly to other aspects of risk management for operations in the United States. MRM does not necessarily have to be managed or governed differently than other risks at U.S. operations (credit, market).

[1] It is important to note that while the Federal Deposit Insurance Corporation (FDIC) did not join the Federal Reserve and OCC in issuing the MRMG, the FDIC does support the content of the guidance and generally expects firms to have sounds MRM practices.