

Embracing validation

Since the Fed's crackdown on model validation in 2014, banks seem to be taking heed. This year was no exception

A couple of years ago, supervisors at the US Federal Reserve had the temerity to start enforcing long-standing – but largely neglected – guidelines on model validation. They did so through the all-purpose policy toolkit that is the Fed's annual stress test of large US banks, the comprehensive capital analysis and review.

Among other things, it meant US banks had to start applying the same kind of validation practices to shop-bought models as they did to those they built in-house – an entirely sensible policy that triggered a high-stakes tug-of-war between the banks and their vendors. Banks had to meet the Fed's expectations or risk failing the test on qualitative grounds; some vendors had to confront a culture of proprietorial secrecy.

Speaking to *Risk* in 2014, banks confessed they were some way from getting the access they needed.

Since then, each of the surveys accompanying *Risk's* annual ranking of technology firms has asked respondents about their ability to validate vendor models, and have shown a broadly improving picture.

Just over 70% of 534 respondents claim to be able to properly validate all of their vendor models this year, and more than 85% say they have

problems with no more than two vendors in total. Only 2% claimed to have problems with six or more vendors – a drop from last year's 5%.

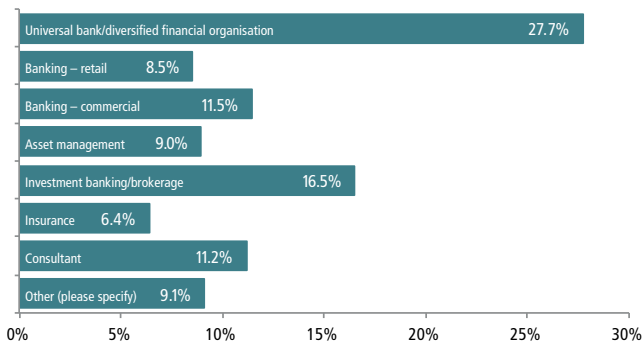
This is also an improvement on sentiments expressed during the early months of the Fed's validation crackdown. At the time, a source at one Wall Street dealer claimed it would fall short of the regulator's standards for all 50 of the vendor models it was seeking to validate. A model risk manager at regional bank PNC said only 25% of its vendor models would pass muster.

Where banks do still encounter problems, this year's survey suggests they are taking them seriously. Nearly 20% of respondents said they had cut an existing vendor – or rejected one during a competitive process – because of validation shortcomings.

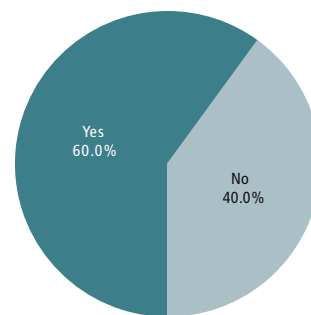
And strong-arm tactics are also being used: 13.6% of respondents said they had threatened to cut a vendor because of model validation issues.

This suggests a slight hardening of the line. Last year, only 15.8% of banks had cut or rejected a vendor because of validation problems, and 12.9% had threatened to do so. ■

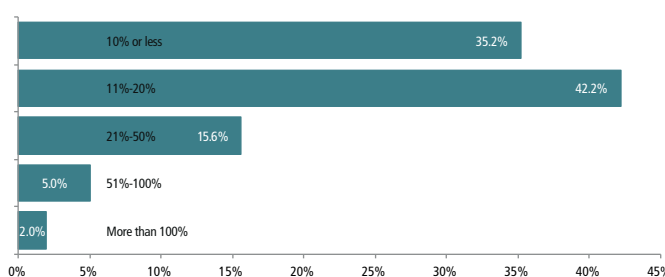
1 What is the primary business of your company?



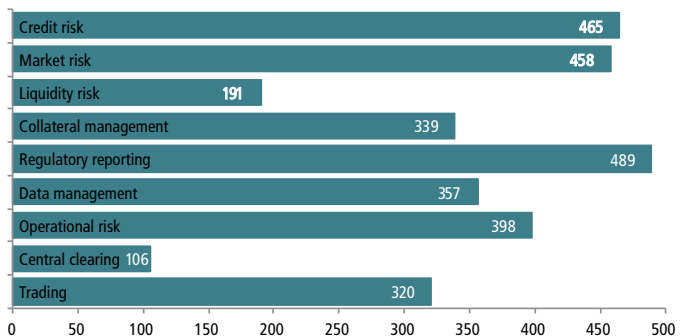
2 Do you expect to increase your spend on technology in 2017?



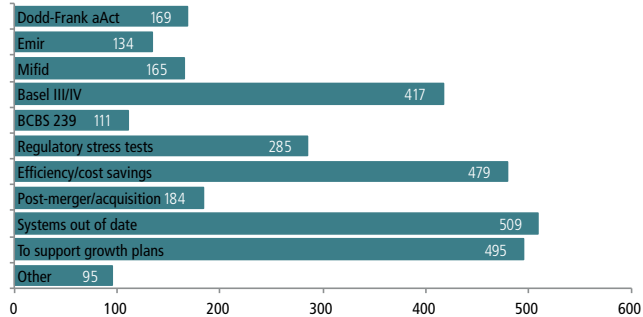
3 If yes, how much more do you anticipate spending?



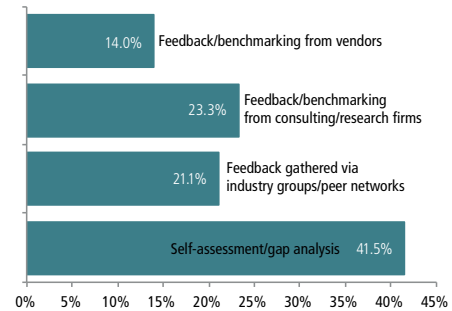
4 Which three areas (in order of priority) will you be looking to invest most in?



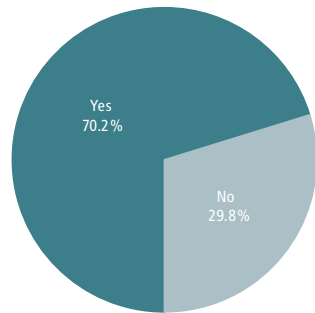
5 What are the three main drivers for the increased technology spend (in order of importance)?



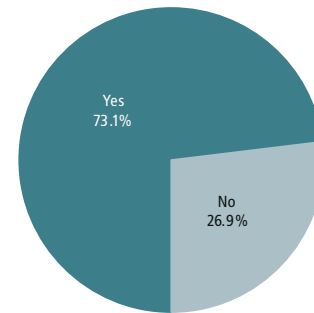
6 What is your most important source of information when assessing new technology spending needs?



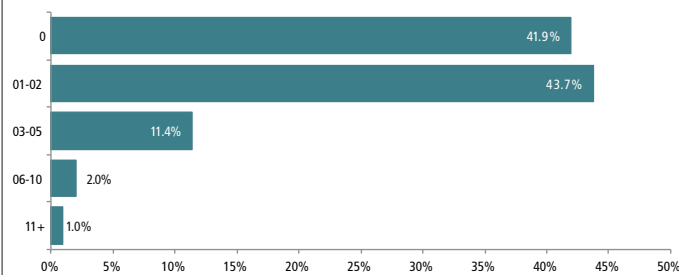
7 Are you able to properly validate all of your vendor models?



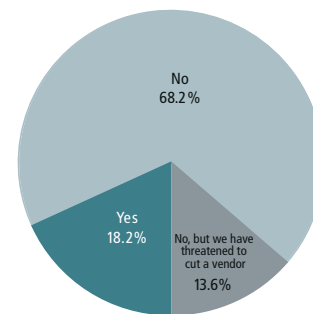
8 If no, are the vendors in question providing the information you need?



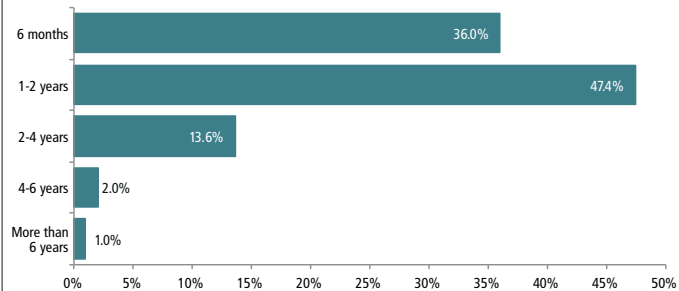
9 How many vendors do you have problems with?



10 Over the course of this year, have you selected a vendor – or dropped an existing provider – because of validation shortcomings?



11 How long will it take to bring your data quality/data aggregation capabilities up to the levels expected by regulators?



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