Session III.A
Supervisory Expectations of the use of Judgment in the Projection Process

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How does judgment impact modeling?

- Ultimately, all statistical approaches embed judgment
- There are obvious, explicit uses of judgment, such as when a management overlay is applied to address known weaknesses
- There also are implicit uses of judgment that occur throughout the process, starting with the choice of data, which can have just as significant an impact, if not greater, on the overall result

Published Supervisory Expectations

- *Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice,* August 2013
- *Comprehensive Capital Analysis and Review 2015: Summary Instructions and Guidance,* October 2014
- *SR Letter 11-7: Supervisory Guidance on Model Risk Management,* April 2011

Supervisory Expectations on Use of Judgment

- There are certain risk categories where we expect that there are sufficient reference data, and sufficient experience with performance in stressful periods, to support robust statistical modeling
  - *A good example is PD estimation given that data on borrower default history is more prevalent than say borrower draw behavior is for EAD estimation*
- We also expect larger, more systemically-important firms to be able to rely more on statistical models
- However, a bad statistical model is not better than a well-supported, qualitative approach
- There are some cases where expert judgment or qualitative approaches should be used as the primary approach
  - *Particularly true if there are material data limitations, or unique risks of a certain portfolio that are not well represented in reference data*

Standards in Use of Expert Judgment

- BHCs should have a transparent, repeatable, well-supported process that generates credible estimates that are consistent with assumed scenario conditions

- In addition, any qualitatively derived projections or adjustment should be subject to effective review and challenge by an independent group
  - ➢SR 11-7 applies to both quantitative and qualitative approaches; however, the standards may be different
    - Qualitative approaches may be reviewed by an independent party outside of the validation unit;
    - Level of statistical testing may be less, but there is still an expectation that firms conduct some type of quantitative assessment or performance evaluation to demonstrate that the models are performing as intended

Standards in Use of Expert Judgment: Model Overlays

- Most BHCs use some form of expert judgment to overlay modeled outputs
  - May be used to account for unique risks of certain portfolios not captured by the models or to compensate for data limitations, model weaknesses
  - Temporary vs. longer-term overlays
- There is no supervisory expectation that overlays are inherently bad
  - Per SR 11-7, *"An understanding of model uncertainty and inaccuracy, and a demonstration that the bank is accounting for them appropriately, are important outcomes of effective model development, implementation, and use."*
- However, such adjustments should be well supported, documented, reviewed and challenged
  - Model overrides or overlays should be subject to oversight and review by an independent party
  - Firms should anchor judgment in empirical analysis and ensure that the users of model output understand the dependence on the overlay
  - A better practice is to conduct sensitivity analysis around the estimates, particularly to support less empirically-supported assumptions