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# WHAT IS EFFECTIVE CHALLENGE?

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One of the most common criticisms clients receive from examiners in relation to their model risk management (MRM) process or a specific validation is: "management failed to demonstrate effective challenge." But what exactly is effective challenge, and what can an institution do to ensure effective challenge is sufficiently occurring?

From a regulatory standpoint, effective challenge is defined as: critical analysis by objective, informed parties that can identify model limitations and produce appropriate changes; effective challenge depends on a combination of incentives, competence and influence. The guidance further elaborates on the incentives, competence and influence highlighting the importance of independence, proper compensation, corporate culture, technical knowledge and arming the MRM function with explicit authority and stature within the organization.

While many view effective challenge as a predominately MRM-managed activity, in reality it requires effort and activity on the part of all "three lines of defense," including model developers/owners/managers, model risk management and audit. Moreover, it requires good communication – just having a reference to effective challenge in a validation report or board memo does not make it real. Comprehensive effective challenge requires a well thought-out strategy and a framework that includes sufficient understanding and critical contributions from each line of defense.

## MODEL DEVELOPERS, OWNERS AND MANAGERS

As the first line of defense, model developers, owners and managers have a responsibility to properly implement and/or manage a model – this requires sound implementation and testing practices and robust documentation. The documentation should sufficiently describe the model, its purpose and intended use(s), known limitations, sources and usage of data and assumptions, processing, reporting, governance/change controls and ongoing monitoring. The ongoing monitoring activities – whether performed by the model manager or by MRM – should periodically inform stakeholders as to the model's performance in relation to its purpose, and highlight if/when a model is in need of an adjustment or recalibration. Insufficient model management practices, poor documentation, lack of transparent change control and inadequate ongoing monitoring often contribute to issues with effective challenge.

## MODEL RISK MANAGEMENT

MRM – as a standalone function or encompassed within audit – is where effective challenge is established and nurtured. The effective challenge process starts with setting and managing expectations for model development and management practices as summarized above. Second, MRM needs to establish and maintain a model validation process that ensures that independent review and challenge is being performed at a sufficient depth by qualified experts. Third, MRM needs to demonstrate that effective challenge is occurring as defined by the MRM policy and through validation documentation. Fourth, MRM needs to demonstrate that it has sufficient authority and organizational stature by exhibiting the ability to stand up to challenges from the lines of business or executive sponsors with model identification, risk weighting assignment or validation findings and conclusions.

## AUDIT

The third-line of defense is the ultimate backstop to the effective challenge process. Audit's role is to first look at the established MRM framework, defined roles and responsibilities and expected activities, and confirm that these all meet regulatory guidance and current industry practices. Second, audit needs to evaluate the first line's performance and confirm that model developers, owners and managers are building/implementing, testing and maintaining/updating their models as expected, keeping documentation up to date, performing the ongoing monitoring and communicating results. Third, audit needs to confirm that MRM is maintaining sufficient independence from model development and management, and to ensure that in-house or third-party validators have the proper level of competence. Audit also needs to ensure that the skills and validation scope align with the nature and complexity of each model, and that model validation is asking challenging questions, including with respect to the documentation surrounding this process. Finally, audit should be looking to ensure that evidence of MRM's stature and authority within the organization exists and is well documented.

It's important to note that establishing a successful effective challenge process is not a "one and done" event – it takes continuing education and reinforcement to promote good model management practices, an ongoing monitoring process that appropriately alerts models owners and MRM to when a model is in need of potential improvement and effective documentation that clearly informs stakeholders how effective challenge is occurring.