

Post AXA Rosenberg/SEC Enforcement Action Model Risk Benchmarking Survey

April 2011

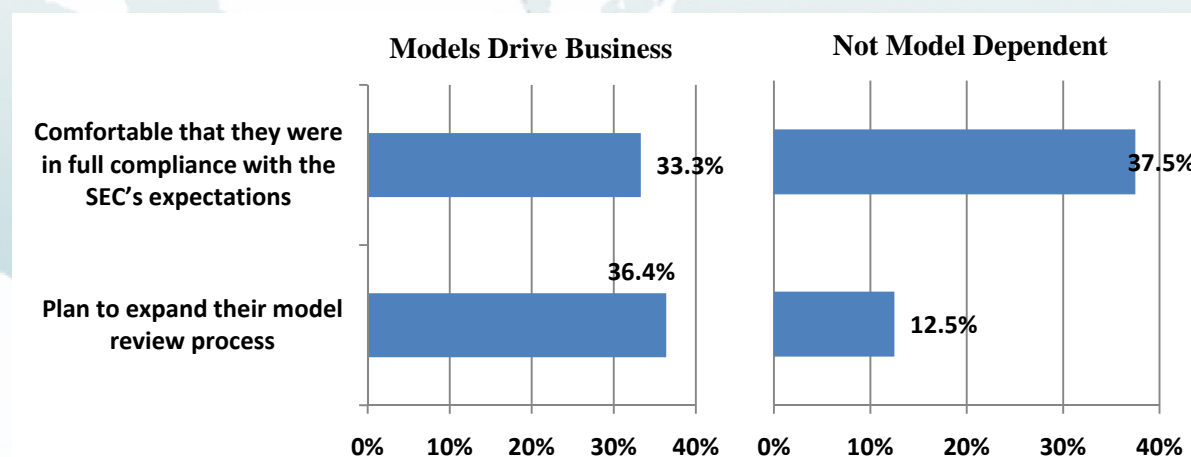


In the wake of the AXA Rosenberg/SEC Model Risk [settlement](#), Capital Market Risk Advisors ([CMRA](#)), a pre-eminent risk advisory boutique celebrating its 20th Anniversary and the International Association of Financial Engineers ([IAFE](#)), a not-for-profit, professional society dedicated to fostering the profession of quantitative finance, conducted a benchmarking survey of market practice concerning model risk.

The SEC settlement may foreshadow new rules governing model disclosure and oversight not only for quant funds but for banks, insurance companies, asset managers and Institutional Investors. Financial institutions often do not review models used for investing or hedging to the same rigorous standards as models used in financial statements or disclosures. Institutional Investors, likewise, do not always subject ALL models to robust model review nor do they always review the approach of managers to model reviews as part of their due diligence process. One possible result of the SEC settlement could be the application of much greater review and oversight requirements on investment and hedging models as well as on spreadsheets.

Overall

- 41.1% of respondents do not escalate model errors
- 42.0% of respondents were surprised by the SEC's concern with models not related to financial reporting or disclosure and/or by the implication that model errors should be disclosed to the investors
- Among respondents where "models drive business", only 33.3% were comfortable that they were in full compliance with the SEC's expectations

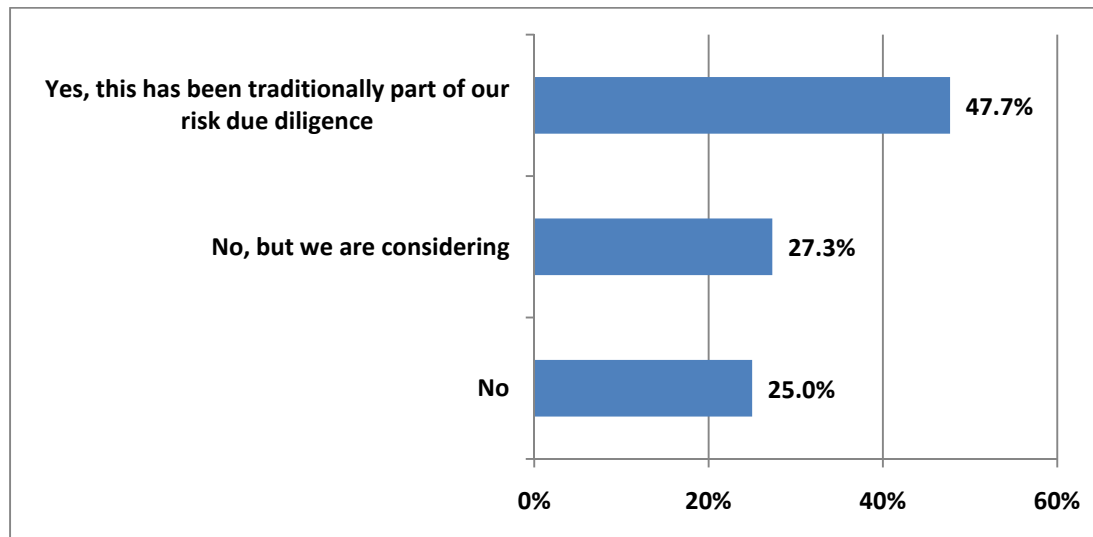


- 36.4% of respondents where “models drive business” plan to expand their model review process but only 12.5% of those that are not model dependent plan to do so
- When presented with a list of 13 model “changes”, the participants disagreed as to which were “errors” and which were “enhancements”; there is not a clear consensus on when a “change” or “enhancement” becomes an “error”
- Only 48.5 % of respondents have an independent quality control group and 28.6% use the model developer to test models
- 25.0% of respondents plan to take a wait and see approach on how to interpret the SEC’s intentions or they haven’t thought about it yet

Investor Due Diligence

- Among Institutional Investor respondents, only 47.7% currently include a discussion of risk governance of models as part of their due diligence process

If you are an investor, do you discuss model risk governance as part of your due diligence?

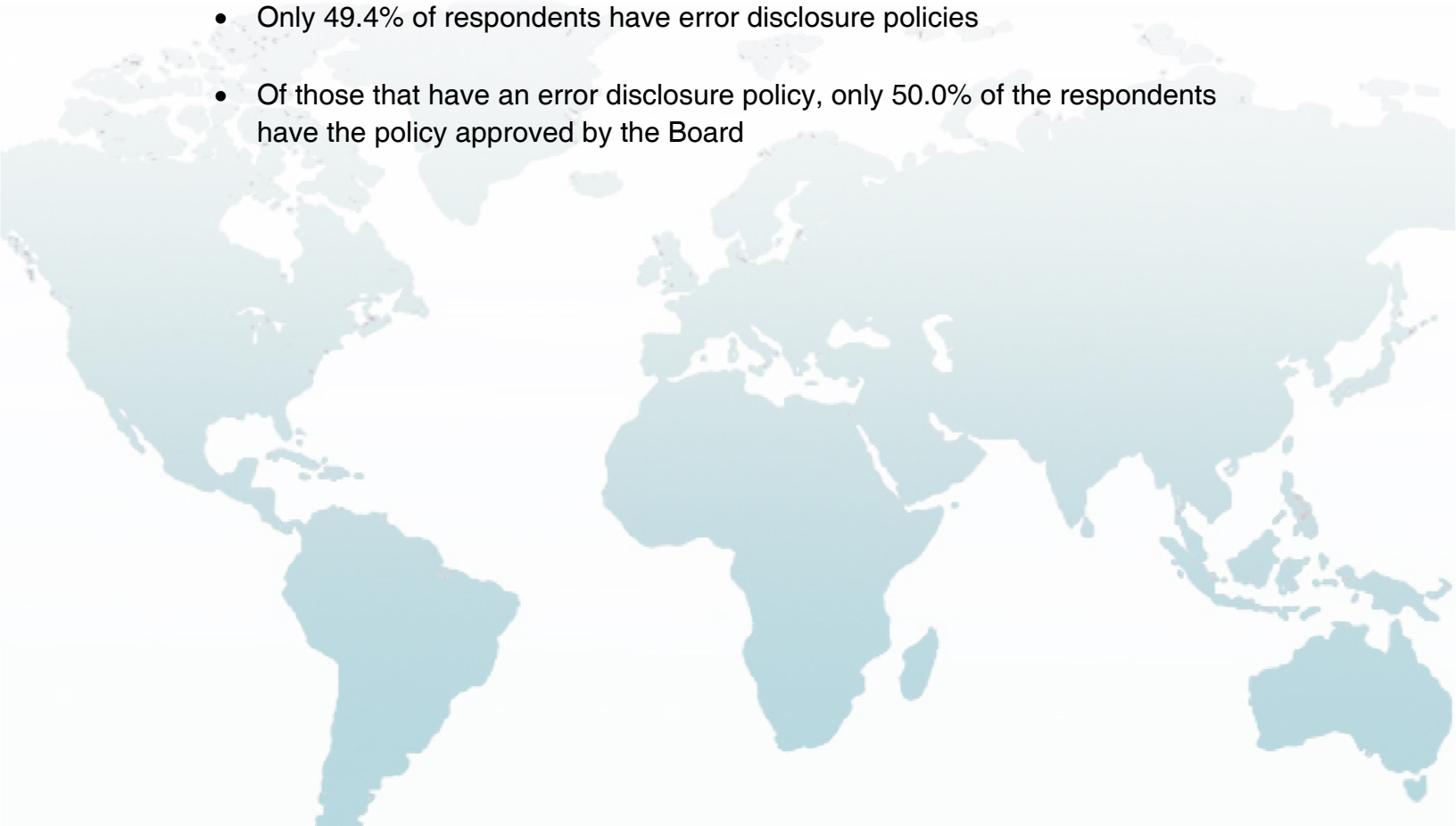


Model Review Policies

- 66.2% of respondents have a model review policy
- Of those with a model review policy, only 50.9% of respondents indicate that it is approved by the Board
- 27.3% of respondents do not compare their model results to those of other commonly used models
- 28.1% of respondents don't have a policy for spreadsheets or 3rd party vendors
- 36.8% focus their review at the time of their release only while 63.2% review models on an ongoing basis
- 28.6% of respondents indicated that model reviews were conducted by the model developer rather than independently

Error Disclosure Policies

- Only 49.4% of respondents have error disclosure policies
- Of those that have an error disclosure policy, only 50.0% of the respondents have the policy approved by the Board





EXPERIENCE MATTERS

Capital Market Risk Advisors (CMRA) is a pre-eminent risk advisory, risk governance, expert witness, and litigation support boutique. Founded in 1991, we offer clients a unique perspective based on Founder [Leslie Rahl](#), Partner [Peter Niculescu](#), and CMRA's Managing Directors Dave Tyson, Frank Iacono, and Richard Horwitz's years of hands-on experience in the evolution of derivatives, risk management, hedge funds, risk governance, structured securities and other complex financial instruments and capital markets issues. We work with asset managers, hedge funds, plan sponsors, mutual funds, banks, insurance companies, and other market participants. Our advisory services includes assessing risk exposures and advising on risk management and strategy, the valuation of complex or illiquid instruments, benchmarking risk management and risk governance practices against best practice, performing comprehensive investment, operational and risk due diligence, advising senior managers and boards with respect to all types of risk management and risk governance issues, developing risk appetite statements, advising on risk reporting and communication, and reviewing and drafting risk management and policies and procedures.

The synergy between our advisory and litigation practices helps us provide advisory clients with insight about what can and does go wrong and provide litigation clients with insight about prevailing industry standards. For more information please go to www.cmra.com or call us at 212.404.6100.



LESLIE RAHL

Leslie Rahl founded CMRA 20 years ago. She is a derivatives pioneer and was Co-Head of Citibank's Derivatives Group in the 80's and on the Board of ISDA for 5 years. She is an experienced Board and Risk Committee Member. She is the author of Hedge Fund Risk Transparency: Unravelling the Complex and Controversial Debate and the editor of Risk Budgeting: A New Approach to Investing. She has an SB from MIT and as SM/MBA from the Sloan School of MIT.



**PETER
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Mr. Niculescu is a Partner at CMRA and heads Fixed Income Advisory. Peter was an Executive Vice President at Fannie Mae, where he ran the Capital Markets division, responsible for acquisition of securities and loans on balance sheet and for their hedging and funding. During the 1990's, Peter was a Managing Director at Goldman Sachs, where he was responsible for Mortgage and Fixed Income Research. He has a Ph.D from Yale in Economics and is a Chartered Financial Analyst charter-holder.



The IAFE is a not-for-profit, professional society dedicated to fostering the profession of quantitative finance by providing platforms to discuss cutting-edge and pivotal issues in the field. Founded in 1992, the IAFE is composed of individual academics and practitioners from banks, broker dealers, hedge funds, pension funds, asset managers, technology firms, regulators, accounting, consulting and law firms, and universities across the globe. For more information please go to www.iafe.org