Model Risk of Risk Models*

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Abstract

This paper evaluates the model risk of models used for forecasting systemic and market risk. Model risk, which is the potential for different models to provide inconsistent outcomes, is shown to be increasing with market uncertainty. During calm periods, the underlying risk forecast models produce similar risk readings; hence, model risk is typically negligible. However, the disagreement between the various candidate models increases significantly during market distress, further frustrating the reliability of risk readings. Finally, particular conclusions on the underlying reasons for the high model risk and the implications for practitioners and policy makers are discussed.

Keywords: Market risk, systemic risk, Value-at-Risk, expected shortfall, MES, CoVaR, financial stability, risk management, Basel III
JEL classification: G01, G10, G18, G20, G28, G38

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