

SR 26 2: THE NEW STANDARD FOR MODERN MODEL RISK MANAGEMENT

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Why SR 26-2 Matters

The new supervisory guidance SR 26-2: *Revised Guidance on Model Risk Management*¹ marks a decisive shift in how financial institutions must govern, validate, and oversee models across the enterprise. The new supervisory guidance supersedes and replaces SR letter 11-7, Guidance on Model Risk Management (issued April 4, 2011) and SR letter 21-8, Interagency Statement on Model Risk Management for Bank Systems supporting Bank Secrecy Act (“BSA”) /Anti-Money Laundering (“AML”) compliance (issued April 9, 2021) and introduces a more explicit and risk-sensitive framework aligned to the modern model ecosystem.

Supervisors now define model risk as a function of inherent risk and materiality, with materiality now determined by the combined assessment of model exposure and model purpose. As the supervisory guidance states, materiality “is no longer a static or single-factor designation,” but a structured evaluation of a model’s financial footprint and its regulatory or strategic significance.

This two-dimensional approach replaces legacy tiering or rating practices with a more transparent, defensible methodology for assessing model risk. For example, models with limited financial exposure but high regulatory purpose such as sanctions screening, fraud detection, liquidity stress testing, or BSA/AML transaction monitoring now warrant elevated scrutiny, while high-exposure operational models may be tiered differently depending on the financial institution’s risk appetite.

A More Precise and Proportionate Governance Framework

Models as defined in the supervisory guidance are simplified representations of real-world relationships. They rely on assumptions that make them useful but also introduce risk to align risk practices with SR 26-2, bank and financial institutions must modernize their internal tiering or rating methodologies and internal governance frameworks.

The supervisory guidance calls for standardized model scoring frameworks that independently evaluate the financial institutions **Exposure** (capital at risk, customer reach, operational

¹ [SR 26-2 attachment: Supervisory Guidance on Model Risk Management](#)

dependency) and **Purpose** (regulatory reporting, supervisory expectations, strategic relevance). This structure enables clear differentiation between models requiring routine monitoring and those demanding heightened oversight and independent validation.

A key supervisory expectation is the consistent and well-documented quantification of a models' **Exposure**, supported by calibration guidelines and cross-business-unit alignment to reduce subjectivity and ensure repeatability.

Heightened Risk Focus

SR 26-2 directs financial institutions to concentrate supervisory attention on models that pose the greatest potential for financial loss, regulatory breach, customer harm, or operational disruption. Financial institutions must also evaluate dependencies and common assumptions across multiple models simultaneously.

As the supervisory guidance notes:

- **Regulatory-purpose models:** Sanctions screening, Fraud detection, Stress testing, Capital, and Liquidity models must receive elevated scrutiny.
- **High-exposure operational models:** Pricing engines, Credit decisioning tools, and Forecasting models must be evaluated for both quantitative impact and customer outcomes.
- **Artificial Intelligence (“AI”) /Machine Learning (“ML”) and vendor-provided models:** require enhanced transparency, documentation, and monitoring due to their complexity and potential for drift or bias.

The supervisory message is clear: model risk management (“MRM”) activities in financial institutions must prioritize the models that matter most to the financial institution.

Inventory Quality and Transparency

SR 26-2 places renewed emphasis on the accuracy and completeness of the model inventory the foundation of effective model risk management. Financial institutions are expected to:

- Identify and classify all models, including AI/ML tools, vendor models, EUCs, and embedded models.
- Remove or reclassify legacy tools that no longer meet the model definition.
- Document lineage, ownership, intended use, data sources, and dependencies.
- Ensure inventory-to-tiering alignment.

Supervisors increasingly view inventory quality as a proxy for model risk management maturity. A fragmented or outdated model inventory signals governance weaknesses in the financial institution and undermines the credibility of the tiering and model validation decisions.

Importantly, the updated guidance excludes simple arithmetic spreadsheets, deterministic tools, and generative/agent AI from formal scope of model risk management, a pragmatic move that allows institutions to focus resources on models that drive systemic financial risk and have a larger business impact.

Core Obligations of Financial Institution

Despite the exclusions cited by the regulators, obligations for in-scope models remain rigorous. Financial institutions must:

- Establish a risk-sensitive tiering framework.
- Ensure independent, proportionate validation of models.
- Maintain strong lifecycle governance, including change management and periodic reviews.
- Document decisions and rationale, especially for tiering, validation scope, and exceptions.
- Provide effective Board and senior management oversight of models within the financial institution.
- Implement controls for AI/ML and vendor models, including explainability and drift monitoring.
- Align model usage with the enterprise risk appetite.

SR 26-2 also strengthens the concept of **Effective Challenge**, requiring independent reviewers with the financial institution with organizational standing and authority to influence outcomes including the ability to halt model deployment when model risks are unmitigated. Model risk management leaders also need a seat at the senior management 'table' to ensure critical and objective to influence and to effect change.

MRM Maturity and Strategic Implications

SR 26-2 also represents a maturation of supervisory expectations. Regulators are pushing institutions to move beyond defensive, checklist-driven compliance and toward a strategic, influential function that protects the balance sheet while enabling safe technological adoption. This shift requires:

- Automated inventory systems with real-time drift alerts.
- Specialized quantitative talent for vendor model back-testing.
- Parallel AI/ML governance frameworks for generative AI.
- Cross-departmental collaboration across MRM, Enterprise Risk Management, Cybersecurity, Data Governance, and Information Technology.

Supervisory guidance also clarifies the role of Internal Audit. Internal Auditors should evaluate the effectiveness of the model risk management practices to assess the framework rigor and

effectiveness and whether related internal control policies are implemented accordingly, not duplicate model validation activities.

Five Key Shifts

To operationalize SR 26-2, financial institutions must execute five practical shifts.

1. **Rebuild tiering frameworks using Exposure × Purpose scoring:** Implement a standardized, quantitative approach reduces subjectivity and aligns oversight with supervisory expectations.
2. **Re-baseline the model inventory:** Apply explicit inclusion/exclusion logic especially for AI/ML, vendor tools, and End-User Computing (“EUC”).
3. **Re-scope validation proportionately:** High-purpose or high-exposure models require deeper testing where low-materiality models require streamlined validation.
4. **Implement AI/ML-specific controls:** Drift monitoring, explainability, feature governance, and bias testing should be embedded into lifecycle governance.
5. **Enhance Board and senior management reporting:** Reporting must reflect the new taxonomy and highlight material models and effective challenge.

Not a Compliance Update

The issuance of SR 26-2 marks a decisive break from static, manual, and siloed approaches to model risk management. The guidance establishes a supervisory expectation that financial institution MRM functions must become dynamic, automated, and deeply embedded in the operating fabric of the financial institution, capable of challenging the businesses, detecting algorithmic drift in real time, and governing the convergence of statistical modeling with increasingly autonomous AI systems.

Compliance with SR 26-2 is not just a policy refresh; it is an operating-model transformation. Financial institutions that modernize accordingly will not only withstand regulatory scrutiny but will build a safer, more resilient foundation for innovation.

The financial institutions that embrace this change in thinking will position themselves to lead in a financial ecosystem where trust, transparency, and algorithmic safety define long-term competitiveness.

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