



From compliance to value: Navigating the SR 26-2 transformation



The first major update to model risk guidance in over a decade codifies industry best practices into a pragmatic, risk-based framework, compelling a strategic evolution of the MRM function.

Executive summary

For years, model risk management (MRM) leaders have been challenged to manage growing model inventories with flat budgets while often being perceived as a bottleneck to innovation. The new SR 26-2 guidance from federal regulators directly addresses this reality. Rather than inventing new principles, SR 26-2 largely codifies and formalizes the best practices that mature MRM functions have begun adopting over the last decade, accelerating the strategic evolution of the MRM function.

For banks, this is a pivotal moment. Firms that embrace this transformation will build leaner, risk-driven, value-additive MRM functions that enable model velocity, reduce control costs, and reinforce trust with all stakeholders.

The new era of MRM

For 15 years, SR 11-7 provided the foundational discipline for MRM. However, its rigidity often required substantial validation capacity toward models that posed immaterial risk to organizations, development and validation testing that was designed to check sensitivity and stability testing boxes, and annual review processes designed to meet SR 11-7's expectations for annual model periodic reviews.

SR 26-2 operationalizes the lessons learned and provides the regulatory backing to manage model risk like any other business risk: by assessing its magnitude and applying a proportionate level of control.

Thematic changes and strategic implications

Key theme	Strategic implication for MRM
1 Prioritization and efficiency	<p>SR 26-2 provides two levers to focus resources:</p> <ol style="list-style-type: none">1. It formalizes risk-based tiering and introduces an “immaterial” designation, providing an expedited path with limited oversight.2. It narrows the model definition to exclude simple arithmetic and deterministic rules-based calculations as well as generative and agentic artificial intelligence (AI), allowing for aggressive inventory de-scoping. <p>What it means: The focus shifts from “validating everything” to a defensible portfolio management discipline. MRM leaders must use this mandate to rationalize inventories, invest in generative AI tooling to press on continuous monitoring, and focus expert validator capacity to the highest-risk models.</p>
2 Pragmatism and flexibility	<p>The guidance introduces flexibility across the MRM lifecycle in three ways:</p> <ol style="list-style-type: none">1. Validation timing: It permits model use before validation is complete to meet an “urgent business need,” provided strict compensating controls are in place.2. Validation scope: It explicitly links the rigor of all validation testing to the model’s assigned risk tier, removing prescriptive requirements.3. Periodic review: It removes the requirement for MRM to periodically review models “at least annually.” <p>What it means: MRM can now operate as an agile business partner. This requires building robust governance for managing exceptions and tailoring validation plans based on risk, not on a generic checklist.</p>
3 Clarified scope, governance, and regulatory stance	<p>SR 26-2 refines the boundaries of MRM and clarifies the regulatory relationship:</p> <ol style="list-style-type: none">1. Scope boundaries: It sets a presumptive \$30 billion asset threshold for applicability.2. Effective challenge: It shifts focus from rigid organizational design to the demonstrable “rigor and effectiveness” of the validation review itself.3. Enforceability nuance: It clarifies that criticism will arise when deviation from the guidance is found in association with evidence of an unsafe or unsound practice. <p>What it means: The clearer scope provides regulatory relief for smaller institutions. The focus on demonstrable challenge provides governance flexibility, while the clarification on enforceability implies criticism will not be issued for noncompliance with the guidance alone. Instead, criticism related to MRM will likely arise from broader reviews where a deviation from the guidance is found in association with other evidence of an unsafe or unsound practice.</p>

Community bank insight

Banks with less than \$30 billion in assets should not interpret the \$30 billion threshold in SR 26-2 as categorical. Language on this topic is vague, such as “most relevant,” “typically,” and “generally.” Where the use of model risk materially contributes to a bank’s risk profile (through complexity or impact to business processes), they should still consider executing appropriate risk mitigation activity.

The business case for transformation

Adopting SR 26-2 is a strategic opportunity; not a compliance exercise. By embracing a risk-based framework, risk and modeling leaders can:

- **Reduce control costs:** De-scoping low-risk tools and tailoring validation scope directly reduces overall level of effort, freeing up expensive quantitative talent to focus on higher-risk activities.
- **Increase speed to market:** The regulatory sanctioning of “provisional use” and a focus on what truly matters allows MRM to move from a gatekeeper to a strategic enabler of innovation.
- **Strengthen defensibility:** A well-rationalized, risk-based framework provides a much stronger and more logical narrative for regulators and auditors than a one-size-fits-all approach.

What institutions should do now

Adapting to SR 26-2 requires a proactive and structured approach. Organizations should not view this as a simple policy update but as an opportunity to re-engineer their MRM function for greater efficiency and effectiveness. The immediate priorities should be::

1

Re-architect the foundation: Enhance your existing tiering framework to ensure appropriate incorporation of concepts of inherent risk and materiality, and formally define the “immaterial” category and its associated, light-touch controls.

2

Rationalize the inventory: Conduct a targeted, systematic review of the model inventory to apply the new, narrower model definition and de-scope nonmodel tools. Confirm controls and risk processes (e.g., EUC programs) that will absorb tools that are dropped out of the model inventory to ensure risk is not unmitigated.

AI risk management insight

Banks should not interpret the exclusion of generative and agentic AI from MRM guidance to be permission to ignore these solutions. Risk mitigation activity performed at the bank should still be commensurate with the risk those tools pose to your institution. Regulators are preparing a request for information on this topic with guidance forthcoming and, in the meantime, banks should be able to evidence sufficient governance (such as the [KPMG Trusted AI framework](#)) and MRM may play a role in that framework.

3

Tailor validation scope: Translate SR 26-2’s statements on testing scope flexibility into a concrete tiering matrix covering the validation pillars. Adjust annual/periodic review practices to be risk-based and, where applicable, identify or design receiving controls for elements that should continue to exist outside of that process (e.g., review of ongoing monitoring outcomes).

4

Operationalize flexibility: Build the formal governance processes and control frameworks required to manage provisional model use and other exceptions safely.

5

Policy revision: MRM policies, committee charters, and documentation templates to embed the new guidance and any changes to governance processes or control frameworks.

6

Define materiality: Proactively build the overarching narrative required to demonstrate how the transformed MRM framework enhances risk management and satisfies safety and soundness principles. The focus must support how more tailored oversight strengthens, rather than weakens, overall governance.

This transformation requires a blend of strategic vision bolstered by technology expertise. Proactive institutions that move quickly will not only ensure compliance but also build a competitive advantage through a leaner, more agile, and value-driven model risk management function.

How KPMG can support your transformation

KPMG helps the world's leading financial services institutions navigate complex regulatory change. We work with clients to operationalize the SR 26-2 evolution by delivering:

Inventory rationalization

Our teams apply well-established methodologies and accelerators to help you rapidly and defensibly rationalize your model inventory, unlocking immediate capacity and cost savings.

MRM target operating model redesign

We work with you to enhance your tiering methodology to align with SR 26-2 and redesign your MRM operating model for a more efficient, risk-based future.

SR 26-2 readiness assessment

We provide independent assurance through mock exams and gap analyses to give your board and senior management confidence that your updated framework is regulator-ready while identifying actionable recommendations for enhancement.

Drawing on deep financial services experience, we help our clients build a modern operating model to reduce control costs, accelerate time-to-value, and manage risk with confidence.



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