



TOPICS:

Model Risk

SOURCE:

Federal Reserve System

FED: Revised Guidance on Model Risk Management

- The Federal Reserve SR 26-2 guidance provides **an updated supervisory framework for model risk management (MRM)** applicable primarily to banking organizations with over \$30 billion in assets. It replaces earlier guidance (SR 11-7 and SR 21-8) and **reflects advancements in modeling practices and supervisory experience.**
- The document emphasizes a **risk-based and principles-driven approach**, requiring institutions to tailor MRM frameworks to their **size, complexity and model risk profile.**
- A central concept is **model materiality**, determined by combining **model exposure (business impact)** and **model purpose (e.g., regulatory or risk management use)**. Higher-materiality models require more rigorous oversight. Additionally, institutions are expected to assess **aggregate model risk**, accounting for interdependencies across models and shared assumptions.
- The guidance outlines key components of the model lifecycle:
 - a) **Model development and use:** Models must align with business objectives, incorporate sound

- assumptions, and undergo appropriate testing. Clear understanding of limitations is critical, particularly when models are used beyond their original purpose;
- b) **Validation and monitoring:** Independent validation should assess conceptual soundness, performance (via outcomes analysis), and ongoing reliability. Monitoring must detect performance deterioration and trigger recalibration or redevelopment where necessary;
- c) **Effective challenge:** Institutions should ensure independent, expert review with sufficient authority to influence model changes.
- Governance is a core pillar, requiring **clear roles and responsibilities, robust documentation and comprehensive model inventories.** Internal audit functions should evaluate the effectiveness of MRM frameworks rather than duplicate validation activities.
- Finally, the guidance addresses **third-party/vendor models**, emphasizing that institutions remain accountable for validating and monitoring such models despite limited transparency into proprietary components.

