

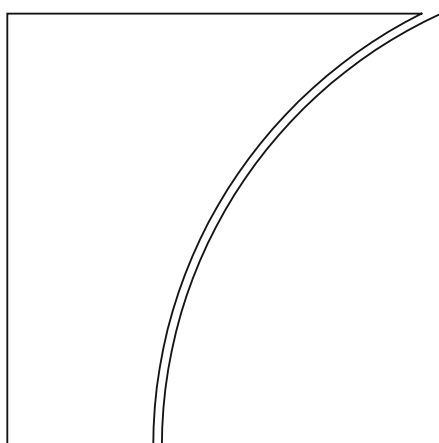
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Acting under uncertainty – the case for supervisory risk appetite frameworks

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Acting under uncertainty – the case for supervisory risk appetite frameworks¹

Executive summary

The two major banking crises of this century – the 2007 Great Financial Crisis (GFC) and the March 2023 banking turmoil – exposed significant weaknesses in banks’ governance and risk management practices and the effectiveness of supervision. These crises demonstrated how poor governance and risk culture in firms can erode market confidence, trigger liquidity runs and destabilise financial systems. They also underscored the financial stability consequences of weaknesses in supervision – such as difficulties for supervisory authorities (SAs) in identifying and addressing material risks before they escalate into systemic concerns. Weaknesses in culture are often the root of these shortcomings.

While international standard setters such as the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) have introduced reforms to strengthen governance and culture within banks, similar efforts have not been widely undertaken in SAs. When deficiencies in supervision are identified, post-mortem reports often fail to examine the broader cultural underpinnings of delayed or inadequate supervisory actions. This omission leaves a critical gap in understanding whether and how SAs’ culture contributes to these weaknesses.

Supervisory risk – the risk that an SA’s actions or inaction fail to achieve prudential objectives – can itself undermine financial stability. This risk stems from internal factors, such as weak governance and culture of SAs, or inadequate tools, processes and methodologies that underpin day-to-day supervision. It can also arise from external factors (beyond the SA’s control) such as resource constraints, unclear or conflicting mandates, shifts in the supervisory pendulum or inadequate powers.

Supervisory risk cannot be fully eliminated. SAs operate with finite resources, expanding responsibilities and imperfect information, and within complex financial systems. Efforts to fully eliminate supervisory risk are unrealistic and may be undesirable, as excessive interventions that seek to minimise firms’ risk-taking may undermine their ability to support the real economy. Effective supervision therefore requires SAs to recognise and manage inherent trade-offs in pursuing prudential objectives.

Risk appetite frameworks (RAFs) that are adapted to SAs’ safety and soundness mandate offer a structured approach to addressing these challenges. Designed to enhance governance and culture in firms, RAFs consist of three main components: (i) well defined risk appetite statements (RAS); (ii) measurable implementation indicators; and (iii) robust governance arrangements. When tailored to SAs, RAFs offer tangible benefits. These include defining acceptable supervisory risk boundaries, aligning strategic goals with day-to-day supervision and articulating trade-offs in achieving prudential objectives. RAFs also facilitate prioritisation and risk-based decision-making – including a focus on risks that matter the most – while fostering consistency and accountability in supervisory decisions. By focusing on the most significant risks, RAFs can help SAs manage resources more efficiently and minimise unnecessary costs to firms. In doing so, they also support ongoing efforts to modernise prudential frameworks by making supervision more risk-focused, proportionate and operationally efficient.

Despite the importance of supervisory risk, international standards do not include specific provisions for SAs to develop RAFs to manage it. The Core Principles for effective banking supervision (BCPs) set minimum standards for the prudential regulation and supervision of banks across jurisdictions,

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outlining expectations for banks and banking supervisors. While various principles require banks to establish and implement RAFs, they do not impose equivalent obligations on SAs.

To date, very few SAs have adopted RAFs in managing supervisory risk. Notable exceptions include Canada's Office of the Superintendent of Financial Institutions (OSFI) and the European Central Bank (ECB) Single Supervisory Mechanism (SSM). OSFI's RAF prioritises system-wide effectiveness and integrates supervisory, regulatory, operational and strategic risks into its framework. The ECB/SSM's narrower risk tolerance framework (RTF) focuses exclusively on supervisory risk, particularly the consistency of prioritisation and risk scoping across institutions. Both frameworks aim to enhance supervisory effectiveness by fostering consistency and accountability while empowering supervisors to exercise judgment.

This paper presents a framework for designing and implementing RAFs that are tailored to the safety and soundness mandate of SAs, aiming to enhance their governance, culture and effectiveness. These elements, outlined below, create a two-way feedback loop: supervisory RAFs reinforce an SA's risk culture while also relying on a strong culture for effective implementation:

- **Define supervisory risk and other risk categories that are subject to the RAF:** SAs need to consider whether the RAF will focus solely on supervisory risk or include other related risks. The boundaries of supervisory risk should be defined, including whether legal risk forms part of its definition. These choices inform the development of the RAS and the accompanying quantitative and qualitative risk indicators.
- **Formulate risk appetite scales with clear definitions of each scale:** Risk appetite scales should balance granularity and practicality, providing sufficient differentiation while remaining simple to implement. Each level should correspond to distinct supervisory postures, influencing the intensity, intrusiveness and form of supervisory engagement.
- **Develop high-level RAS:** The RAS – aspects of which could be made public – should clearly articulate the SA's tolerance for supervisory risk, considering both internal factors (within the SA's control) and external factors (outside of its control) that shape it. This provides stakeholders with clarity on the trade-offs made in fulfilling the SA's mandate. As all SAs face varying resource constraints amid increasing responsibilities, the RAS should also explicitly promote the use of supervisory judgment and risk-based supervision, within an environment of psychological safety.
- **Operationalise the RAS through qualitative and quantitative indicators:** To translate RAS into supervisory practices, SAs should consider developing qualitative and quantitative indicators and/or relevant assessment criteria. These indicators should map to relevant risk appetite scales.
- **Establish effective governance arrangements, including an independent second line function:** SA leadership should approve the RAF, set its supervisory risk tolerance and remain accountable for supervisors' prioritisation decisions. An independent second line function should oversee RAF application, monitor risk appetite interpretation across supervisory teams and maintain dashboards to track limit breaches. Lastly, feedback loops and periodic reviews are essential for RAFs to remain effective.

There may be scope for developing international guidance to support the adoption of supervisory RAFs. This could include formulating an internationally harmonised definition of supervisory risk and establishing criteria in the BCPs to set minimum expectations for supervisory RAFs.

Ultimately, the level of supervisory risk an SA is willing to tolerate is not fixed but reflects deliberate policy choices of legislative bodies and the overall governance and culture shaped by SA leadership. A well designed RAF provides a structured approach to manage these choices, balancing the need for proactive supervision with the realities of operational constraints. In this way, a RAF can transparently reflect the dynamic nature of supervision, ensuring that key stakeholders understand the consequences of their decisions and the trade-offs involved in achieving prudential objectives.

Section 1 – Introduction

- 1. Weak risk culture in firms is often cited as a root cause of nearly all bank failures, including prior episodes of banking sector distress.** The March 2023 banking turmoil provided a stark reminder that material qualitative shortcomings in governance and risk culture, if left unaddressed, can result in a crisis of confidence and trigger catastrophic liquidity runs (Balan et al (2025)). While there are various definitions of culture, the Financial Stability Board (FSB) defines culture as “the institution’s norms, attitudes and behaviours related to risk awareness, risk-taking and risk management” (FSB (2014)).
- 2. In response, international standard setters introduced reforms to strengthen risk culture in banks, including requirements to develop and implement an effective risk appetite framework (RAF).** The FSB defines the RAF as a firm’s overall approach through which risk appetite is established, communicated and monitored (FSB (2013)). It includes a risk appetite statement (RAS), risk limits and mechanisms to oversee its implementation. The RAS outlines the specific types and levels of risk a bank is willing to accept, using both qualitative and quantitative measures. In short, the RAS provides the parameters in which senior and line staff are expected to operate. It is put into practice by establishing and communicating relevant risk limits at the business line level. Its implementation is monitored through governance mechanisms that enable independent oversight, evaluation and timely correction of any deviations. Together, these three elements are considered instrumental in fostering a strong risk culture and supporting firms’ prudent risk-taking and long-term resilience.
- 3. Recurring incidents of banking crises also reveal supervisory shortcomings, but the ensuing investigative reports rarely explore whether the institutional culture within supervisory authorities (SAs) contributed to delayed or inconsistent supervisory responses.** Most post-mortem reports typically focus on gaps in supervision or regulatory shortcomings tied to firm-specific failures, rather than examining the broader impact of SAs’ overall culture on these incidents² (BCBS (2023), FINMA (2023)). This may be due in part to the difficulties in (i) identifying the key factors that drive supervisory culture and (ii) establishing links between supervisory culture and gaps in supervision. As a result, the cultural underpinnings of delayed supervisory actions often remain the missing piece in post-crisis learnings, even though they may be central to understanding the root cause of supervisory weaknesses.
- 4. These episodes highlight the importance of a strong supervisory culture to underpin effective supervision and underscore the need for all SAs to define and manage supervisory risk.** Supervisory risk – the risk that the SA, operating within its mandate, fails to identify, address or mitigate prudential risks within regulated entities in a timely and effective manner – can itself be a source of financial instability. While supervision is a powerful tool for promoting prudent behaviour in banks, internal and external factors can undermine its effectiveness. Internal factors can include weak governance and culture of the SA and ineffective supervisory methodologies that can undermine supervisory effectiveness. External factors, including inadequate supervisory powers, resource constraints, the nature of supervisory mandates or shifts in the political pendulum can also influence supervisory risk. The absence of an explicit articulation of supervisory risk appetite can itself constitute a strategic gap, leaving supervisory tolerance levels implicit, unevenly applied and vulnerable to drift over time.
- 5. In practice, SAs operate with an implicit tolerance for supervisory risk.** Supervisory actions are taken under conditions of uncertainty, evolving financial systems and finite supervisory resources amid increasing responsibilities, requiring SAs to continuously calibrate their supervisory posture to ensure

² There are two notable exceptions. First, the US Board of Governors of the Federal Reserve’s (FRB) internal post-mortem review of the failure of Silicon Valley Bank attributed gaps in supervision in part to “a shift in the stance of supervisory policy [which] impeded effective supervision by [...] promoting a less assertive supervisory approach”. See FRB (2023) for details. Second, the Australian Prudential Regulatory Authority’s (APRA) capability review, led by an independent panel, included several proposals to strengthen APRA’s supervisory culture. See APRA (2019) for details.

effective supervision. This calibration involves determining where supervisory attention should be focused, how intensively supervisors should engage, and which risks require timely intervention. When supervisory risk tolerance remains implicit, these judgments may be applied inconsistently across supervisory teams and over time, potentially weakening supervisory effectiveness.

6. **To address these challenges, there is a growing case for SAs to adopt and implement the functional equivalent of RAFs to enhance their prudential supervision of banks.** Such frameworks enable SAs to define the boundaries of acceptable supervisory risk and articulate the inherent trade-offs in their tolerance for these risks. By making these trade-offs explicit, supervisory RAFs help institutionalise proportionality and reduce ambiguity around when intervention is warranted and when supervisory restraint is appropriate. RAFs can help SAs to efficiently allocate – through the use of judgment – scarce supervisory resources to risks and institutions that have a material bearing on the safety and soundness of firms and the financial system. An important dimension of deploying scarce supervisory resources involves taking proportionate, risk-based supervisory interventions, focusing on risks and practices that matter the most. In this way, a well-defined and effectively implemented RAF, tailored to the objectives and specific context of SAs, could strengthen their governance and supervisory culture while helping to align the actions of front line supervisory teams with the SA's broader strategy. Yet, unlike banks, there are no international standards for SAs to develop supervisory RAFs.

7. **To date, very few SAs have a self-imposed internal framework resembling a RAF to support their prudential objectives.** In Canada, the Office of the Superintendent of Financial Institutions (OSFI) introduced a RAF, setting out acceptable levels of risk in its areas of operations³ (OSFI (2023)). In the European Union (EU), the Single Supervisory Mechanism (SSM) of the European Central Bank (ECB) published its risk tolerance framework (RTF) to emphasise that a risk-averse SA does not have an “appetite” for risk in the same way a bank does; rather, the RTF provides a structured way for supervisors to prioritise risks, explicitly signalling that not all risks require the same depth of assessment during each supervisory cycle. The RTF therefore acts less as a set of boundaries (as in the case of OSFI's RAF) and more as an institutional endorsement for supervisory judgment. In both SAs, beyond high-level statements, there is very little in the public domain on how the RAF or RTF (in the case of the ECB/SSM) are implemented in practice and how they help to shape the SA's culture.

8. **This paper uses the RAF terminology as an overarching concept, adapted for application by SAs, comprising three core components.** These elements include: (i) the RAS, which sets out the SA's boundaries for acceptable risks in relation to its supervisory objectives; (ii) implementation of the RAS through supervisory methodologies and practices that guide day-to-day supervisory decisions; and (iii) governance arrangements that provide independent oversight and ensure adherence to the RAS.

9. **Building on this conceptual foundation, this paper examines the design and implementation of RAFs, focusing solely on the safety and soundness remit of SAs, and assesses their implications for strengthening supervisory effectiveness.** While SAs may have broader mandates, such as macroprudential oversight, anti-money laundering (AML) or conduct supervision, the framework developed in this paper is tailored to the safety and soundness objective; nevertheless, the underlying concepts can be adapted for other supervisory mandates. In particular, it examines the nature of a published RAS, explores the methodologies that are or can be used to support its adoption across front line supervisors and reviews the governance/quality assurance mechanisms needed to facilitate effective monitoring and evaluation. The findings are based on a review of relevant international guidance and published RAFs in Canada (OSFI) and the EU (ECB/SSM), supplemented with interviews with senior supervisors from both SAs and the authors' own analysis.

10. **The rest of the paper is structured as follows:** Section 2 frames the RAF architecture within the context of prudential supervision and introduces the concept of supervisory risk, including legal risk.

³ In the United States, the Office of the Comptroller of the Currency (OCC) introduced a supervisory RAS in 2016; however, senior OCC supervisors indicated that it is no longer used to guide the OCC's internal governance. See OCC (2016) for details.

Section 3 compares the nature and granularity of RAFs at the ECB/SSM and OSFI and Section 4 provides a detailed example of how RAFs can be designed, implemented and governed in practice. Section 5 briefly concludes.

Section 2 – Framing the RAF architecture for prudential supervision

Overview

11. **While RAFs were originally designed for banks, the underlying architecture – articulating acceptable risk boundaries, translating them into operational guidance and embedding them within governance arrangements – has broader institutional relevance.** Although SAs do not engage in commercial risk-taking, they must nonetheless define and calibrate acceptable boundaries for the risks they encounter in fulfilling their statutory mandate. This conceptual parallel provides the foundation for adapting the RAF architecture to the supervisory context. Table 1 compares the core components of RAFs in financial institutions and SAs, illustrating both their shared structural elements and the adaptations required to reflect the distinct objectives, accountability arrangements and institutional constraints of prudential supervision.⁴

12. **In the supervisory context, the most consequential risk to be managed is supervisory risk.** This risk can stem from either the actions or inaction of the SA. Heightened supervisory risk can lead to adverse outcomes such as the build-up of unsustainable risks within firms, weakened resilience, bank failures or financial instability.

13. **Supervisory risk is shaped by a range of internal and external factors.** It can arise from internal weaknesses, such as ineffective supervisory methodologies, tools, techniques, processes, judgments, governance or culture, which can undermine the SA's ability to fulfil its mandate. It may also stem from external factors beyond the SA's control, such as resource constraints, inadequate supervisory powers, unclear or conflicting mandates (Kirakul et al (2021)), undue political pressure, shifts in the regulatory or supervisory pendulum, rapid market developments or emerging risks that outpace the SA's capacity to respond.

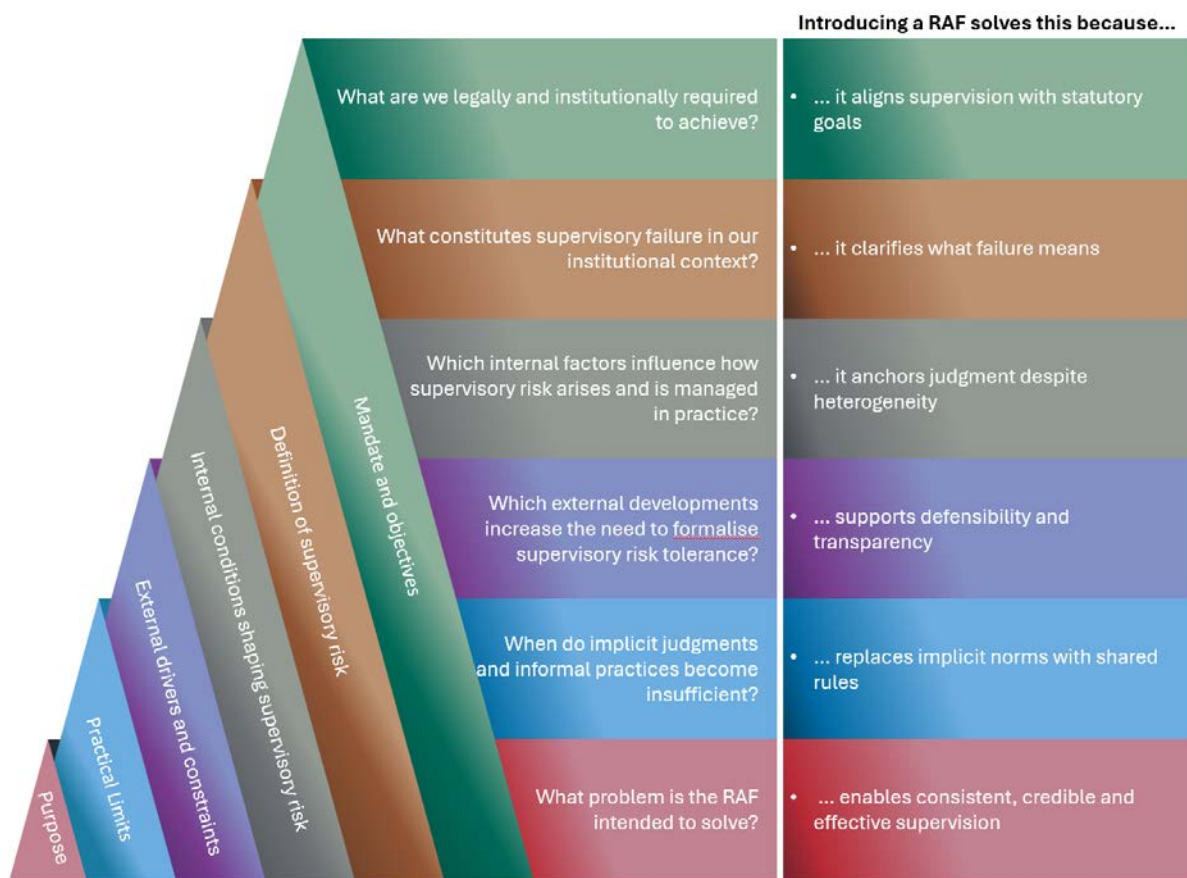
14. **An important subset of supervisory risk is legal risk, which can shape how and when SAs calibrate intervention.** For the purposes of this paper, legal risk refers to the risk that supervisory action or inaction exposes the SA to legal challenge, judicial reversal or mandate failure. It is two-fold: first, it encompasses the risk that intervention is perceived (by financial institutions) to be premature, disproportionate or unsubstantiated, potentially leading to litigation or appeals in hopes of overturning supervisory decisions (litigation risk). It also includes the risk of failing to intervene in a timely or sufficiently forceful manner, which could result in the SA being challenged on the grounds of failing to meet its statutory duty to ensure the safety and soundness of regulated entities (accountability risk).

15. **Legal risk is therefore closely linked to the timing of supervisory actions.** Acting too early or too intrusively may elevate litigation risks or activate the supervisory appeals process, while acting too late may allow prudential vulnerabilities to intensify, increasing both financial stability consequences and ex post accountability, including public scrutiny of supervisory decisions. In this respect, refraining from intervention does not eliminate risk; it reallocates and potentially amplifies it over time. Legal ambiguities – including unclear intervention powers, uncertain evidentiary thresholds, mandate complexity or limited legal protection for supervisors – can materially influence how SAs calibrate the timing, intensity and sequencing of supervisory action.

⁴ See BCBS (2015) on requirements for banks to establish effective RAFs.

	Financial institution	Supervisory authority
Risk appetite statement	<ul style="list-style-type: none"> Defined at board level, expressing tolerance for key risk types such as credit, market, liquidity etc Serves as a strategic compass linking business objectives with desired risk-return outcomes Combines qualitative statements and quantitative thresholds 	<ul style="list-style-type: none"> Anchored in the prudential mandate and supervisory model, setting out the level of risk that can be accepted in fulfilling supervisory objectives Recognises that tolerance levels are influenced by various internal and external factors and can vary by institutional size, complexity and systemic importance
Implementation	<ul style="list-style-type: none"> Operationalised through policies, procedures, controls and limits within the risk management framework Translates strategic risk appetite into day-to-day decisions, monitoring and reporting Relies on robust data, systems and communication channels to ensure alignment across functions 	<ul style="list-style-type: none"> RAS is complemented/supported by the supervisory methodology, which defines key steps such as risk identification, assessment, scoping and follow-up actions Supported by information systems, data analysis and feedback mechanisms that connect strategic planning with operational supervision
Governance	<ul style="list-style-type: none"> Based on the three lines of defence model: business units (1st line), risk and compliance (2nd line) and internal audit (3rd line) Oversight mechanisms ensure accountability, escalation and continuous improvement Board and senior management maintain ownership and oversight of the risk appetite framework 	<ul style="list-style-type: none"> The 1st line comprises day-to-day supervisory activities, while the 2nd line provides challenge, consistency and monitoring Internal and external reviews provide further assurance
Culture	<ul style="list-style-type: none"> Shared norms and behaviours shaping how risks are identified, discussed, escalated and acted upon across the organisation Reinforced by leadership tone, accountability frameworks, remuneration and incentives Determines the effectiveness of the RAF and its day-to-day application 	<ul style="list-style-type: none"> Supervisory mindset and behavioural norms that guide challenge, intrusiveness, consistency, independence and a no-blame approach to identifying and addressing weaknesses Reinforced by internal governance, leadership tone and escalation culture Determines the extent to which the supervisory RAS is embedded in daily supervisory judgment and helps prevent regulatory capture

16. **The decision to formalise supervisory risk tolerance through a RAF is typically shaped by a combination of institutional, organisational and external considerations.** These include the SA’s statutory mandate; its definition of supervisory failure; internal governance and cultural factors; and external pressures such as legal scrutiny, political expectations or resource constraints. Graph 1 summarises these considerations as a set of guiding questions that SAs implicitly confront when deciding whether and how to formalise their supervisory risk tolerance. Introducing a RAF helps address these challenges by aligning supervisory actions with statutory objectives, clarifying the meaning of supervisory failure, strengthening the consistency of supervisory judgment and supporting defensibility under institutional constraints.



Supervisory methodologies and RAFs

17. **The vast majority of SAs worldwide rely on existing supervisory methodologies as the foundation of their supervisory approach, making them the de facto means of managing supervisory risk.** These methodologies include supervisory tools, techniques, manuals and internal procedures which collectively guide day-to-day supervision and provide consistency across supervisory activities. In addition, many SAs have developed quality assurance panels, often embedded within independent supervisory teams, to enhance the quality, consistency and defensibility of supervisory decisions. By introducing independent scrutiny at key decision points, particularly in escalation and enforcement cases, quality assurance mechanisms help mitigate both under- and over-intervention.

18. **While these methodologies are essential to support day-to-day supervision, they function as an implementation mechanism rather than an expression of an SA’s supervisory risk appetite.** Supervisory methodologies and processes provide structure and consistency, but they do not explicitly articulate the SA’s tolerance for supervisory risks, nor do they always set clear expectations for escalation, prioritisation or cultural norms. This creates a gap: methodologies guide what supervisors do, but not always how much risk the SA is willing to tolerate or how consistently supervisory judgment should be applied.

19. **Therefore, most supervisory methodologies only cover aspects of a RAF, often in isolation, without considering the SA’s overall supervisory risk tolerance or the internal/external factors that**

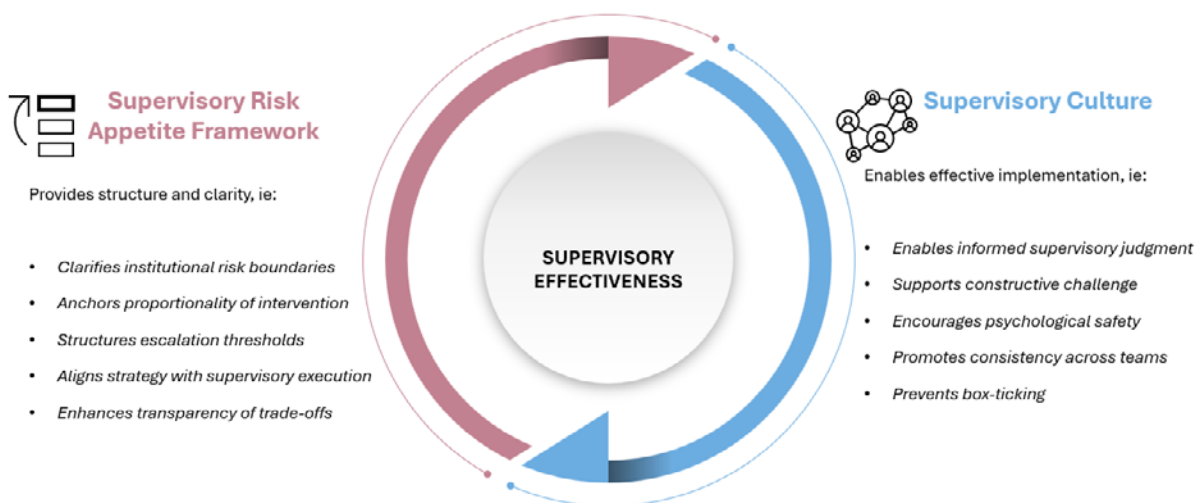
shape it. Supervisory methodologies are often extensive and operationally detailed documents, designed to guide granular supervisory processes rather than to articulate high-level institutional principles. As such, any implicit signals regarding risk tolerance may be dispersed, difficult to interpret or unevenly applied.

20. **A standalone RAF – especially a clearly formulated RAS – addresses this limitation by concentrating core supervisory principles in a single, concise and institution-wide framework.** By explicitly articulating risk boundaries and escalation expectations, it anchors existing methodologies, enhances their coherence and provides a clearer and more transparent foundation for supervisory decision-making, without replacing established processes.

21. **Culture plays a central role in the effectiveness of a RAF, while the RAF helps to reinforce the SA’s culture.** The behavioural norms, supervisory mindset and escalation practices within an SA determine whether the RAS becomes embedded in day-to-day supervision or remains a formal statement with limited influence. In this way, the RAF and supervisory culture are mutually reinforcing (Graph 2): the RAF provides the structure needed to guide supervisory activities and decision-making, which in turn enhances culture. At the same time, a robust culture is essential for successful RAF implementation.

Mutual reinforcement between supervisory RAF and supervisory culture

Graph 2



Section 3 – Design and implementation of RAFs in supervisory authorities

22. **This section examines how two SAs – OSFI (Canada) and the ECB/SSM (EU) – have designed, implemented and governed their RAFs.** While the few publicly available documents provide only a high-level articulation of each SA’s approach, our analysis delves deeper by incorporating insights from detailed interviews with senior officials in both jurisdictions. Specifically, it examines the SAs’ motivations, methodological design choices, application across the supervisory cycle, governance arrangements and cultural implications, offering a comparative perspective on their evolution and implementation. For consistency, the term “RAF” is used throughout to refer generically to supervisory risk appetite or tolerance frameworks; in the ECB/SSM’s case, this corresponds to its risk tolerance framework (RTF).

Motivations for developing supervisory RAFs

23. **SAs introduce RAFs for different reasons, shaped by their institutional histories, mandates and internal supervisory challenges.** Despite these differences, three common drivers emerge: (i) the need for strategic clarity amidst an increasingly complex and uncertain risk environment; (ii) the need for cultural alignment; and (iii) the practical necessity of managing expanding supervisory tasks with finite resources. These drivers often intersect with catalysts such as strategic transformation and evolving supervisory priorities, prompting SAs to refine their frameworks.

24. **Strategic transformation or shifts in supervisory focus can serve as triggers for introducing RAFs.** OSFI introduced its enterprise RAF to address growing risk complexity and support its strategic transformation. Driven by leadership, alongside the creation of a Chief Strategy and Risk Officer role in 2022, the framework filled a key gap by enabling clearer articulation of risk appetite, improving prioritisation and resource allocation, and aligning supervisory and regulatory actions with system-level risks. The ECB/SSM followed a different path: its framework emerged not from leadership turnover but from the SSM's transition from the need to harmonise and consolidate supervisory practices across all member states to a mature and homogeneous steady-state supervision, and the recognition that persistent challenges around lack of resources to tackle all its supervisory functions required an approach that empowered its staff to adequately prioritise tasks.

25. **Expanding supervisory mandates, heightened expectations and finite resources make prioritisation frameworks increasingly necessary.** Both SAs face growing expectations; at the same time they operate under resource constraints and growing pressure to demonstrate proportionality and efficiency. These dynamics make structured trade-offs unavoidable. At OSFI, an expanded mandate (including integrity and national security), rising external risk complexity and the need to better prioritise risks and allocate resources made a coherent RAF essential as the foundation for enterprise-wide risk prioritisation and resilience. For the ECB/SSM, the framework responded to cultural norms and behavioural habits shaped by crisis experience and accountability incentives, which encouraged expansive risk coverage and, at times, diffused supervisory intensity across many areas rather than concentrating resources on the most material exposures. At the same time, there is increasing emphasis across jurisdictions on reducing unnecessary regulatory and supervisory burden on firms, reinforcing the need for more targeted and proportionate supervisory engagement. In this context, the RAF acts as a corrective device, encouraging supervisors to focus on what matters most and to calibrate the depth and scope of intervention accordingly.

26. **Cultural considerations are central to the adoption and design of supervisory RAFs.** In all SAs, supervisory behaviour is shaped not only by processes and methodologies but also by ingrained habits, perceived expectations and organisational norms. In practice, the formalisation of these cultural dynamics through a RAF tends to emerge where institutional scale, coordination complexity or leadership priorities create a need to make supervisory trade-offs more explicit.

27. **Both OSFI and the ECB/SSM have already undertaken extensive work to strengthen supervisory culture, including initiatives focused on judgment, accountability, risk awareness and organisational setup.** The introduction of a RAF therefore reflected a deliberate decision to formalise these existing cultural strengths within a structured, institution-wide framework. Both frameworks are intended to embed a proactive, forward-looking mindset; strengthen confidence in judgment-based decision-making and support risk-based prioritisation across supervisory activities. At the ECB/SSM, cultural objectives are central to the framework: it reinforces prioritisation discipline, supports a no-blame environment, strengthens confidence in supervisory judgment and empowers supervisors to focus on the most significant risks.

28. **RAF also enhance the defensibility and accountability of supervisory choices.** They help document the rationale for supervisory decisions and provide clarity on the trade-offs involved. OSFI integrates escalation routes and governance expectations into its framework, supporting clearer

accountability. At the ECB/SSM, the framework provides a reasonable justification for supervisory priorities and strengthens internal accountability for the selection and scoping of supervisory activities.

RAF architecture

29. **OSFI and the ECB/SSM have taken different approaches to designing their supervisory RAFs, reflecting differences in the frameworks' scope and how it is articulated within the supervisory architecture.** OSFI defines its risk boundaries through a consolidated, enterprise-wide RAF that provides a single reference point for supervisory and organisational risk-taking. The framework is operationalised through a blended approach that integrates bottom-up risk and control self-assessments and top-down focus on systemic impacts, collectively supporting risk management and prioritisation. By contrast, the ECB/SSM does not codify the framework in a single dedicated document; rather, its elements are embedded across supervisory methodologies, processes and governance arrangements, most prominently the RTF used for bottom-up risk scoping and prioritisation, together with top-down supervisory priorities and planning processes. Taken together, these elements perform functions analogous to components of a supervisory RAF.

30. **The differing terminology used by OSFI and the ECB/SSM reflects nuances in institutional framings rather than fundamentally different conceptual choices.** OSFI refers to its framework as a "risk appetite framework", consistent with its enterprise-wide remit and the broader organisational risks it governs. At the operational level, risk appetite is operationalised through defined tolerances, with residual risks aligned within those tolerances. The ECB/SSM adopts the term "risk tolerance", emphasising that supervisors do not seek or pursue risk (in the way financial institutions do), but instead determine the level of residual risk they are willing to accept in fulfilling their mandate. Conceptually, "risk appetite" and "risk tolerance" are alternative ways of expressing acceptable risk boundaries. In financial institutions, the distinction can be economically meaningful, as higher risk appetite may be associated with higher expected returns. In the supervisory context, however, the practical implications are more limited. Whether framed as appetite or tolerance, both frameworks help clarify acceptable boundaries for supervisory decision-making and strengthen accountability for supervisory judgment.

31. **Both SAs use risk categories to articulate the scope of risks and decisions covered by their RAFs.** OSFI employs an enterprise-wide RAF that spans its full institutional risk taxonomy, including strategic, supervisory, regulatory and operational risks, thereby situating supervisory risk within a broader organisational risk landscape. While the framework supports prioritisation at the enterprise level, it also informs the calibration and prioritisation of supervisory activities. By contrast, the ECB/SSM explicitly separates supervisory risk from the other risks it faces as an institution, anchoring its RTF exclusively on aspects of supervisory risk and in particular on tools that support the prioritisation choices made during the risk scoping phase of the supervisory review process. This narrower configuration reflects the ECB/SSM's objective of using the RTF as a lean and transparent prioritisation tool to support risk-based supervision (RBS) and the effective deployment of supervisory resources.

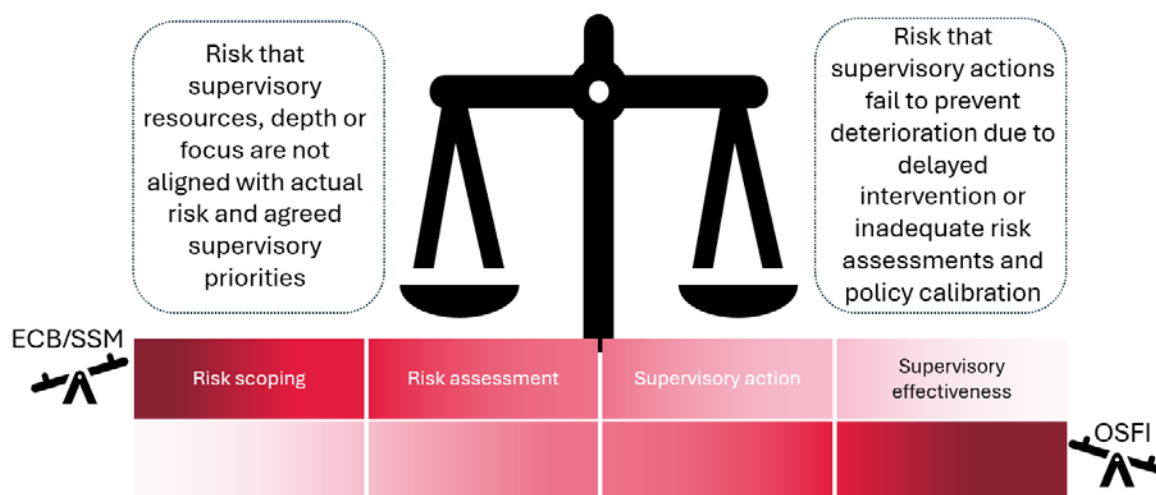
32. **Supervisory risk, the common risk taxonomy used by both SAs, differs primarily in institutional emphasis and in the level at which it is articulated and operationalised at each SA.** At OSFI, supervisory risk is explicitly defined within the broader institutional risk taxonomy and encompasses risks related to supervisory planning and capabilities, preparedness for current and emerging external risks, risk identification and assessment, timeliness and effectiveness of supervisory responses, crisis preparedness and governance and accountability. Articulated through the RAF and applied via risk and control self-assessments, this approach supports a consistent framing of supervisory risk that aligns with organisational strategy and underpins risk-informed decision-making. At the ECB/SSM, supervisory risk is not articulated through a standalone formal definition. Instead, it is embedded operationally within the RTF, which concentrates on the prioritisation, consistency and quality of supervisory execution as the principal pathway through which effectiveness is secured. In this approach, supervisory risk arises when

supervisory work is insufficiently prioritised, inconsistently applied or carried out with insufficient intrusiveness or timeliness.

33. **Within supervisory risk, the breadth of coverage also diverges.** OSFI’s RAF for supervisory risk adopts a broader remit, covering both prudential regulation and outcome-oriented supervision. It also considers its expanded mandate related to integrity and security risk. Within the realm of supervision, OSFI’s RAF implicitly includes risk scoping, risk assessment and supervisory actions, which, taken together, support supervisory effectiveness. Risks to these activities are then assessed against risk tolerance to determine which risks should be prioritised and mitigated. By contrast, the ECB/SSM’s application of supervisory risk within its RTF excludes regulatory and supervisory policy guidance⁵ and focuses solely on risk scoping and the allocation of supervisory attention. In this context, the depth and nature of supervisory reviews are dynamic to allow supervisory teams the necessary flexibility to perform the referred risk scoping. This narrower application reflects the ECB/SSM’s emphasis on using its RTF as a tool for transparent prioritisation and the efficient deployment of supervisory resources, which in turn set the broader context for the supervisory review process.⁶ Graph 3 illustrates the different approaches taken at the ECB/SSM and OSFI.

Supervisory risk – Institutional design choices at the ECB/SSM and OSFI

Graph 3



34. **Scales are used to express supervisory tolerance levels, but their design differs.** OSFI applies a four-level scale – ranging from “very low” to “high” appetite – and offers examples at both ends of the spectrum, enabling supervisors to position risks within a clearly defined range of supervisory acceptance. The ECB/SSM takes a different approach: although it internally describes “low”, “moderate” and “high” tolerance levels in very broad terms, their practical application is confined to risk scoping and prioritisation of supervisory activities.

35. **These scales also reflect differences in calibration logic.** OSFI calibrates tolerance to the potential consequences of supervisory failure at the authority-wide level. Missing risks in a less material institution may be acceptable within a moderate tolerance range, whereas failures with systemic implications fall within a very low tolerance zone. Overall, supervision is expected to be risk-based and align with a regulated entity’s size, complexity and potential impacts to the financial system. By contrast,

⁵ For the purposes of this paper, “supervisory policy guidance” refers to guidance issued to the industry as opposed to internal supervisory methodologies.

⁶ With the same intention as that of OSFI to drive the institution to become more outcome-oriented, the ECB/SSM has also established a framework for evaluating supervisory effectiveness; however, it is separate from the RTF.

the ECB/SSM's RTF reflects a firm-specific approach, operating as a prioritisation tool within the supervisory planning cycle: supervisors determine the effective tolerance by assessing the materiality of an issue (bottom-up) and its alignment with annual supervisory priorities (top-down). The interaction of these elements determines the effective tolerance applied to each bank and risk area. As such, the ECB/SSM's framework structures how supervisory effort is allocated within each institution, identifying which risk areas warrant deeper scrutiny and which risks may be relatively deprioritised. At a broader level, for both SAs, overall supervisory intensity – including resource allocation, on-site inspections and thematic reviews – continues to reflect the systemic footprint of each institution, such as its size, complexity and cross-border relevance.

36. **Both SAs place a strong emphasis on qualitative statements rather than quantitative thresholds.** Frameworks in both jurisdictions rely on qualitative descriptions that provide a high-level articulation of what is expected of supervisors and what outcomes are within tolerance. For example, OSFI's statements characterise situations such as delayed supervisory action or emerging governance weaknesses without specifying numeric triggers. At the operational level, supervisors do leverage quantitative metrics to inform risk management activities. Future iterations of the RAF will further integrate these metrics to support continued proactive risk identification. Similarly, the ECB/SSM's RTF indicates that material and priority-aligned risks require supervisory attention, without prescribing quantitative thresholds for when such risks become unacceptable. Quantitative indicators are used as inputs to judgment rather than to drive decisions. For example, supervisors may monitor numeric key risk indicators (KRIs), such as the number of days a finding remains overdue, the volume of missed remediation milestones, the percentage of unresolved high-severity issues or the recurrence rate of findings across cycles, to inform whether supervisory tolerance should be lowered (OSFI) and/or the intensity of engagement increased (ECB/SSM). Table 2 compares the design of RAFs at OSFI and the ECB/SSM.

37. **While supervisory RAFs may differ, both SAs share a common objective of fostering effective supervision.** OSFI's articulation of the RAF can be viewed as largely path-independent, as supervisory risk is assessed primarily in terms of whether prudential objectives are ultimately achieved. The RAF also reinforces proportional focus by articulating where OSFI is prepared to take more or less risk, helping supervisors tailor the level of scrutiny to an entity's material risk exposure and potential systemic impact. The ECB/SSM's approach includes embedding supervisory risk considerations within the stages of the supervisory cycle and reflecting the view that effectiveness is shaped by how risks are scoped, prioritised and acted upon over time. By emphasising disciplined risk scoping, top-down strategic priorities and bottom-up relevance assessments, the RTF introduces clearer front-end control points that shape subsequent supervisory actions and influence how supervisory intensity is allocated within the risk areas of each supervised institution. Both approaches ultimately pursue the same objective of effective supervision.

Differences and similarities in RAFs

Table 2

Driver	OSFI	ECB/SSM
Name	Risk appetite framework – reflecting the level and type of risk the SA is willing to accept in pursuit of its mandate	Risk tolerance framework – suggesting that supervisors accept, rather than seek, residual risk
Applicability	Articulates tolerance levels at the OSFI-wide level and is operationalised via a blend of top-down and bottom-up risk assessments	Operationalised at the level of individual institutions through risk-based scoping and supervisory planning, while also considering top-down supervisory priorities
Taxonomy	Enterprise-wide RAF covering the full institutional risk taxonomy (includes strategic, supervisory, regulatory and operational risks)	Framework limited to aspects of supervisory risk only
Definition of supervisory risk	Explicit, outcome-based definition	No standalone formal definition; embedded operational articulation
Breadth within supervisory risk	Broader coverage, includes regulation and all aspects of supervision	Focus on risk scoping and allocation of supervisory attention
Risk scales	Four-level scale (“very low” to “high”); provides examples	Three broad tolerance levels (low, moderate, high) described conceptually
Calibration approach	Tolerance calibrated by risk materiality, acceptable deviation from risk appetite and alignment with supervisory priorities	Tolerance determined by risk materiality and alignment with supervisory priorities
Quantitative metrics	Quantitative thresholds are very limited; KRIs are under development and used selectively by supervisory teams; qualitative statements dominate	Benchmarking across supervisory teams may involve the use of KRIs, but no thresholds

Embedding the RAF into the supervisory cycle

38. **The RAF is effective when transformed from a high-level statement of intent into a practical instrument in day-to-day supervision.** SAs use the framework to shape key aspects of supervision, including planning/risk scoping decisions, risk assessments, supervisory communication/actions and, where necessary, escalation. SAs have either developed or are in the process of developing tools for monitoring their stated risk appetite/risk tolerance with actual supervisory practices. Feedback loops further ensure that the RAF evolves over time, adapting to changing supervisory mandates, risks and organisational priorities.

39. **The annual planning process is the primary entry point for embedding the RAF into supervisory activities.** During planning, the framework provides the structure for defining supervisory themes, determining the appropriate level of intensity and allocating resources. Consistent with the architectural distinctions described earlier, the ECB/SSM’s RTF shapes the supervisory examination plan for each institution by structuring how supervisory priorities and bank-specific material risks translate into supervisory intensity and resource allocation. OSFI likewise anchors its annual supervisory plans in its enterprise-wide RAF, using it as a guide to determine risk-based supervisory activities. In both cases, the planning process ensures that RAF principles shape the earliest and most consequential supervisory decisions.

40. **At the risk assessment stage, the RAF begins to influence actual supervisory choices.** Supervisors adjust depth and focus of supervisory activities (eg on-site work, off-site analysis etc) according to the materiality of the risks identified during the planning phase and the SA’s tolerance for

leaving residual risk unaddressed. At the ECB/SSM, this derives directly from supervisory teams' risk scoping decision: the RTF informs which modules merit a full review in a given year, which can undergo lighter analysis and which may be deferred within the multi-year supervisory cycle without breaching tolerance levels. At OSFI, the RAF embeds proportionality more directly. Systemically important institutions are subject to high intensity and very low tolerance for missed risks, while lower-tier institutions may be assessed with reduced intensity, reflecting a higher tolerance for residual risk. In all cases supervisory intensity is risk-informed and aligned with the RAF.

41. **Supervisory dialogue, including written communication, provides another avenue for embedding RAF principles.** At the ECB/SSM, the RTF increasingly shapes how findings and measures are articulated, ensuring consistency between stated priorities, prioritised assessments and communicated outcomes. Similarly, OSFI's communication practices prompt supervisors to provide institutions with a concise top-priority list of the most pressing issues requiring action. This approach reinforces the focus and urgency conveyed by the RAF.

42. **Escalation is one of the clearest tests of whether a RAF is genuinely embedded in supervisory practice.** When supervisory tolerance is exceeded – whether due to unusually long remediation timelines, persistent weaknesses, inadequate responses from institutions or simply too-high risk levels – structured escalation routes come into play. Both the ECB/SSM and OSFI have increased appetite for timely escalation, supported by the RAF. At the ECB/SSM, escalation is governed by an escalation ladder and dedicated guidance but is not part of the RTF itself. However, the RTF provides the tolerance logic within which supervisors judge that risks can no longer be accepted, while the escalation guidance provides one operational pathway for intensifying supervisory action. OSFI has an explicit high risk appetite for being proactive (eg willing to intervene early) and agile in its risk assessment and intervention activities. In practice, this means supervisors may escalate without hesitation, refresh risk assessments and supervisory ratings as conditions evolve and adjust supervisory expectations or guidance when existing approaches are no longer adequate.

43. **These escalation behaviours operate within different legal and institutional constraints.** The interplay between supervisory judgment and legal risk tolerance defines how far and how fast supervisors can escalate. Supervisors must balance autonomy in judgment with the legal risk carried by their escalation decisions. OSFI approaches legal risk through staged escalation: early interventions can be taken rapidly, while later-stage actions require greater legal scrutiny. By contrast, at the ECB/SSM, willingness to escalate earlier and more forcefully is not articulated through an explicit RAS for legal risk. Instead, it is expressed implicitly through internal supervisory guidance, ECB Board-level decision-making and an evolving supervisory culture. In this setting, increasing the Board's appetite for earlier and stronger escalation inherently raises the likelihood of legal challenge, a trade-off leadership signalled a readiness to accept in order to protect supervisory credibility and effectiveness.

44. **Operational tools translate qualitative appetite statements into practical decision support mechanisms.** At the ECB/SSM, dashboards track the application of prioritisation and challenge teams that take on too much (and fail to sufficiently prioritise risks), reflecting the centrality of risk scoping in its framework. Annual benchmarking exercises further support consistency by comparing supervisory team behaviour and adherence with supervisory methodologies across supervised firms. At OSFI, KRIs and scenario grids are being built out to connect qualitative statements to quantifiable indicators. These tools aim to support more consistent interpretation across divisions and reflect OSFI's broader, enterprise-wide RAF architecture.

45. **Feedback loops ensure continuous improvement, gathering evidence on RAF implementation and informing periodic refinement.** OSFI conducts quarterly monitoring meetings to reconcile bottom-up risk assessments with top-down expectations, and misalignments trigger recalibration or follow-up discussions. At the ECB/SSM, supervisory behaviour is monitored through dashboards, challenge processes and cultural pulse surveys that provide insight into whether the RTF is

correctly understood and applied. These feedback mechanisms prevent the RAFs from becoming static, supporting their evolution alongside changes in supervisory mandates, risks and organisational priorities.

46. **Regular updates to the RAF keep it aligned with a continuously evolving external environment.** As new risks emerge and organisational priorities shift, SAs need mechanisms to ensure that their frameworks remain strategically relevant. OSFI provides a clear illustration of this dynamic approach: three years after the initial implementation of its RAF, it initiated a refresh to incorporate a new mandate covering national security and integrity risks and emerging risks and opportunities. This periodic review reflects OSFI's governance philosophy, which emphasises the importance of keeping the RAS aligned with evolving priorities and the broader risk environment. In addition, OSFI's Annual Risk Outlook (ARO) informs the RAF by identifying and prioritising emerging and top risks, ensuring that risk appetite levels are aligned with the external risk environment and supervisory priorities. The ECB/SSM follows a more principles-based model that emphasises stability of the conceptual framework while allowing flexibility in annual implementation. Although the rules of the RTF tool itself are intentionally high-level and require minimal maintenance, incorporation of new or emerging risks occurs through the annual definition of supervisory priorities set at the ECB-wide level. These priorities, refreshed each year by the Supervisory Board, directly influence the tolerance levels applied in the RTF and shape the multi-year prioritisation process used by supervisory teams.

Governance and institutional ownership of the RAF

47. **Top-level endorsement is essential for RAF legitimacy.** At OSFI, the Superintendent (eg the head of the SA) spearheaded the design of the RAF as part of the broader strategic transformation, in hopes of embedding the RAS into the DNA of the SA. Within the ECB/SSM, the Supervisory Board's approval and communication of the risk tolerance statements help to facilitate RTF operationalisation across supervisory teams. In both cases, top-level endorsement signals strategic commitment.

48. **The first line supervisory function plays a crucial role in implementing the RAF.** In both OSFI and the ECB/SSM, the first line (eg front line supervisory teams) is responsible for making prioritisation choices related to supervisory activities, forming supervisory judgments and determining the appropriate level of scrutiny. At OSFI, risk appetite is defined at the enterprise level but cascaded through division-specific risk and control self-assessments, creating a traceable link from the Superintendent's intent to the actions of supervisory teams. At the ECB/SSM, supervisors' assessments and prioritisation decisions are validated by senior management (housed within the front line functions), ensuring that supervisory judgments align with the SA's stated tolerance levels and supervisory priorities.

49. **The second line reinforces this accountability by providing independent challenge and promoting consistency.** At OSFI, the Enterprise Risk Management and supervisory quality assurance functions – both independent of front line supervision – review adherence to risk appetite, assess whether supervisory judgments align with institutional tolerance levels and identify areas requiring escalation or recalibration through targeted reviews and deep dives. At the ECB/SSM, the second line function, which reports directly to the Chair of the Supervisory Board, conducts cross-team benchmarking and reviews, acting as a counterweight to tendencies toward over- or under-scoping and providing challenge across risk assessment, ongoing monitoring and escalation decisions. Beyond methodological consistency, it plays an important cultural role by challenging supervisors' natural inclination toward exhaustive risk coverage and anchoring the framework in practical prioritisation choices. Across both SAs, this tiered governance structure ensures that framework decisions are not left to individual interpretation but follow a structured chain of supervisory judgment, validation and challenge, helping prevent "framework drift" and supporting consistent application across teams and institutions. Formal processes are in place to resolve disagreements, with material divergences escalated to senior management and the board when necessary.

50. **Second line functions that oversee the RAF are typically compact, senior and analytically focused, but their size and scope vary across SAs.** These functions are typically staffed with seasoned supervisors who combine methodological expertise with practical supervisory experience, enabling them to challenge prioritisation decisions and promote consistent application of the framework. At the ECB/SSM, beyond assessing the consistency and proportionality of risk scoping and prioritisation decisions (the primary focus of the ECB/SSM's RTF), the second line also sets top-down supervisory priorities, conducts regular risk identification and monitoring, carries out evaluations and benchmarks supervisory practices across supervisory teams. It also integrates organisational readiness into the annual planning cycle, ensuring that supervisory resources are aligned with stated priorities. These priorities cascade into horizontal on-site planning, reinforced by practical risk tolerance tools that help supervisors distinguish essential tasks from non-essential tasks. At OSFI, second line oversight of the RAF is distributed across specialised functions that together provide independent challenge, assess alignment with risk appetite and support escalation or recalibration where supervisory practices diverge from institutional tolerance. Despite organisational differences, second line functions in both SAs play a critical role in reinforcing prioritisation discipline, supporting accountability and ensuring that the RAF is applied consistently rather than diluted through individual interpretations.

Supervisory culture

51. **The effectiveness of a supervisory RAF depends not only on its formal design but also on the surrounding supervisory culture.** A well designed framework can only shape behaviour if it is supported by cultural conditions that enable supervisors to exercise judgment, prioritise deliberately and accept residual risk. Yet, based on interviews with both SAs, supervisors may be more risk-averse and inclined toward caution. In this sense, culture does not replace or subsume the RAF; rather, it conditions whether the framework can operate as intended. This makes empowerment a central objective of RAFs: for example, the ECB/SSM explicitly reinforces a no-blame environment. ECB leadership has repeatedly stressed that prioritisation decisions should not expose teams to hindsight criticism; accountability sits at senior level, while supervisors are encouraged to make informed trade-offs. This cultural shift – from “cover everything” to “focus on what matters most” – is fundamental to the RAF's purpose. OSFI's high appetite for early intervention plays a similar function, encouraging supervisors to act decisively even in the presence of imperfect information.

52. **Incentives must also align with the goals of the RAF to support its implementation.** If supervisory success is measured by the volume of issues identified or the breadth of coverage, risk-based choices and de-scoping could be perceived as bad supervisory judgment. The Expert Group⁷ mandated to assess the effectiveness of the supervisory review process at the ECB noted that incentives and evaluation systems should reward prioritisation and the ability to distinguish material risks from non-material risks. OSFI's quarterly calibration process similarly reinforces the message that supervisors are expected to align their work based on materiality of risks.

53. **Despite the emphasis on culture and incentives, SAs may face entrenched cultural frictions that can pull them away from RBS.** These include a tendency toward broad, spread-thin coverage; hesitation in adjusting risk scores (eg composite supervisory ratings assigned to firms) and challenges in ensuring timely intervention. Supervisors may naturally gravitate toward completeness and thoroughness, traits reinforced by professional identity, peer norms and the fear of missing emerging risks. RAFs seek to counteract this by reinforcing prioritisation discipline. At the ECB/SSM, supervisors historically viewed comprehensive (risk scoping) coverage as synonymous with quality; the RTF was introduced precisely to break this pattern and help teams distinguish between essential tasks and deferrable tasks. Another ECB/SSM-specific cultural challenge is “score stickiness”, where supervisors may hesitate to adjust

⁷ See Dahlgren et al (2023), in particular Recommendation 3.2: Strengthen prioritisation of qualitative measures and the role of the escalation process (p 43).

composite risk ratings due to concerns about consistency across supervisory teams, rising supervisory expectations or potential signalling effects toward institutions.

54. **By contrast, OSFI's supervisory culture does not exhibit the same cultural pull toward exhaustive risk scoping coverage, but risk-based early intervention may require adjustments over time.** OSFI's supervisory model embeds proportionality through tiering in its supervisory rating system⁸ and differentiated tolerance levels, guiding supervisors to calibrate intensity according to institutional materiality. The RAF reinforces this culture but also allows for proactive and agile intervention, recognising that supervisory activities may need to be adjusted as conditions change.

55. **Training, repeated dialogue and leadership messaging are essential to align supervisory behaviour with RAF expectations.** Both SAs emphasised that embedding the framework requires sustained reinforcement rather than one-off communication. At the ECB/SSM, extensive training on culture, judgment and prioritisation supports consistent interpretation of the RTF and forms part of a broader multi-year supervisory culture initiative aimed at fostering behavioural change across the SSM, enabling supervisors to act in a more risk-based, efficient and integrated manner. At OSFI, engagement occurs through division-level risk and control self-assessments, ongoing monitoring and targeted training activities, which together build a shared understanding of risk appetite and reinforce expectations around proportionality and risk-based decision-making.

Section 4 – Operationalising RAFs in supervisory authorities

56. **This section provides an illustrative example of how RAFs can be operationalised in SAs.** This includes: (i) determining and defining the risk categories, including supervisory risk, that are subject to the RAF; (ii) formulating risk tolerance scales with clear definitions of each scale; (iii) developing high-level RAS; (iv) operationalising the RAS through qualitative and quantitative indicators covering key areas of the supervisory review process; and (v) establishing governance arrangements, including mechanisms to incorporate feedback loops to update the RAF as circumstances warrant. It is important to emphasise that the ensuing discussions are not meant to be an authoritative guide on this topic and there may be other valid approaches to introducing RAFs in SAs. For the purposes of this section, the terms risk appetite and risk tolerance are used interchangeably.

Step 1 – Define risk taxonomy

57. **The starting point is to determine and define the risk categories that are covered by the RAF.** The SA needs to decide whether to focus exclusively on supervisory risk or to extend the framework to include other related risks. If the decision is made to focus solely on supervisory risk, it is important to define its boundaries, ie which elements should be included within this category. For illustrative purposes, Box 1 provides a definition of supervisory risk, which serves as the primary reference point for developing risk appetite scales, the RAS and the accompanying quantitative and qualitative risk indicators in the stylised example.

58. **The proposed definition of supervisory risk is limited to SAs with a safety and soundness mandate and focuses on outcomes: that is how well SAs execute core supervisory tasks that comprise the supervisory review process.** This includes risk scoping, risk assessment, supervisory communication and actions, and monitoring and escalation. These tasks, both individually and collectively,

⁸ OSFI segments all regulated entities into five tiers (based on size, complexity and potential impact of the firm's failure on the financial system), which determine the granularity of its risk assessment. Institutions that fall into the top three tiers are subject to more granular risk assessments, including a more detailed assessment of additional risks. This approach prescribes (rather than relying on supervisory judgment) the granularity of risk scoping decisions taken at the largest institutions.

are critical to identifying and addressing prudential risks within regulated entities in order to safeguard the resilience of firms and the stability of the financial system. Other functions – such as licensing/authorisation, regulatory policy development and macroprudential oversight – are intentionally excluded from our definition. While these functions may influence supervisory risk, they may or may not fall under the SA’s remit based on institutional arrangements. SAs may choose to expand the definition of supervisory risk beyond what is noted in Box 1 or include additional risk categories based on their specific priorities and institutional responsibilities.

59. **Legal risk is included within the definition of supervisory risk given its close linkages with supervisors’ ability and will to take timely actions.** We identify two dimensions of legal risk and their interactions with an SA’s overall supervisory risk appetite: (i) litigation risk and (ii) accountability risk. Notably, there is a positive correlation between accountability risk and overall supervisory risk appetite, but a negative correlation between litigation risk and supervisory risk appetite. In particular, a higher tolerance for litigation risk (eg the SA is willing to accept uncertain legal outcomes) is consistent with a low supervisory risk appetite, while the inverse is true for an SA with a low litigation risk appetite (lower tolerance for uncertain legal outcomes). While SAs may adopt different positions on the litigation risk appetite spectrum, it is important to note that a low litigation risk appetite may conflict with an expectation for supervisors to address risks well before breaches of prudential requirements occur. Therefore, supervisory RAFs should ensure that litigation risk is managed in a way that supports rather than hinders timely and effective intervention.

Box 1

Definition of supervisory risk,^① including legal risk (stylised example)

The risk that an SA, operating within its mandate, fails to identify, address or mitigate prudential risks within regulated entities in a timely and effective manner. Heightened supervisory risk can lead to adverse outcomes such as the build-up of unsustainable risks within firms, weakened resilience, bank failures or financial instability.

Legal risk, a subset of supervisory risk, refers to the risk that supervisory actions expose the SA to legal challenge, judicial reversal or mandate failure due to various legal ambiguities or constraints (eg inadequate legal protection of supervisors, unclear legal powers to take early actions, lack of an early intervention mandate, uncertain evidentiary thresholds or mandate complexity etc). It is two-fold: first, it encompasses the risk that intervention is perceived (by financial institutions) to be premature, disproportionate or unsubstantiated, potentially leading to litigation or appeals in hopes of overturning supervisory decisions. Legal risk also encompasses the risk that the SA fails to take relevant actions as required under applicable laws, regulations and mandates, including failure to intervene in a timely or sufficiently forceful manner. Table A below shows how both dimensions of legal risk are – positively or negatively – correlated with an SA’s supervisory risk posture.

Table A

Supervisory posture	Supervisory risk	Litigation risk	Accountability risk (Mandate failure risk)
Early/intrusive intervention	↓	↑	↓
Delayed/insufficient intervention	↑	↓	↑

Source: FSI staff analysis.

^① Supervisory risk primarily focuses on the effectiveness of and the outcomes that result from core supervisory activities, such as on-site inspections, off-site monitoring, horizontal reviews and other functions that are integral to the supervisory process. These include: (i) risk scoping; (ii) risk assessment; (iii) supervisory communication and actions; and (iv) monitoring and escalation. Each of these activities plays a critical role in identifying, assessing and addressing prudential risks within regulated entities and fostering the safety and soundness of banks and the banking system.

60. **The SA must also remain mindful of the various jurisdiction-specific factors that influence supervisory risk.** Table 3 identifies a non-exhaustive list of both internal and external elements that can, collectively, act to either amplify or mitigate supervisory risk. These factors should be carefully considered when determining the SA's overall tolerance for supervisory risk.

Key factors shaping supervisory risk				Table 3
	Factor	Description	Amplifies supervisory risk	Mitigates supervisory risk
Internal factors (within the SA's control)	Supervisory methodologies and processes	Frameworks governing scoping, assessment, escalation and follow-up	Lack of frameworks governing scoping, assessment, escalation and follow-up	Clear, proportionate and regularly updated methodologies support consistent judgments and risk-based choices
	Supervisory guidance (for the industry)	Expectations, interpretative guidance and supervisory communications directed at supervised institutions	Overly high-level, vague or internally inconsistent guidance creates uncertainty for institutions and supervisors	Well calibrated guidance that balances principles with practical expectations supports predictability, comparability and timely escalation
	Supervisory tools and data	Availability of analytical tools, dashboards and benchmarks	Poor-quality data or fragmented tools obscure risk signals and increase detection risk	Integrated, forward-looking tools enhance early identification and comparative analysis
	Supervisory judgment/culture	Norms governing discretion, challenge and escalation	Risk aversion, box-ticking or fear of escalation delay intervention	Leadership signals that encourage early judgment and challenge support timely action
	Skills and experience of supervisors	Technical expertise and supervisory maturity of line staff	Skill gaps or high turnover weaken assessment quality and execution	Experienced supervisors apply judgment effectively under uncertainty
	Governance and second line challenge	Oversight, review and escalation mechanisms	Weak challenge allows inconsistencies and framework drift	Strong, independent second line challenge anchors consistency and accountability
External factors (largely outside the SA's control)	Operational independence	Degree of freedom from political or industry influence	Political interference constrains escalation and weakens credibility	Strong statutory independence enables timely and effective supervision
	Mandate design	Breadth and clarity of supervisory objectives	Objectives misunderstood as conflicting (eg safety vs growth) blur priorities	Clear primacy of safety and soundness sharpens risk-based decisions
	Supervisory resources	Staffing, funding and technical capacity	Persistent under-resourcing forces reactive and shallow supervision	Adequate resourcing enables depth, continuity and follow-up
	Supervisory powers	Legal authority to intervene and enforce	Limited powers or high proof of burden delay or weaken corrective action	Graduated and enforceable powers support proportionate escalation
	Legal protection of supervisors	Protection against personal liability	Weak protection discourages early supervisory intervention and the will to exercise judgment	Strong protection supports timely, decisive action
	Political and policy environment	Stability of supervisory expectations over time	Shifts toward laissez-faire increase tolerance for supervisory delay	Stable policy signals support consistency and long-term planning

Step 2 – Develop risk tolerance scales

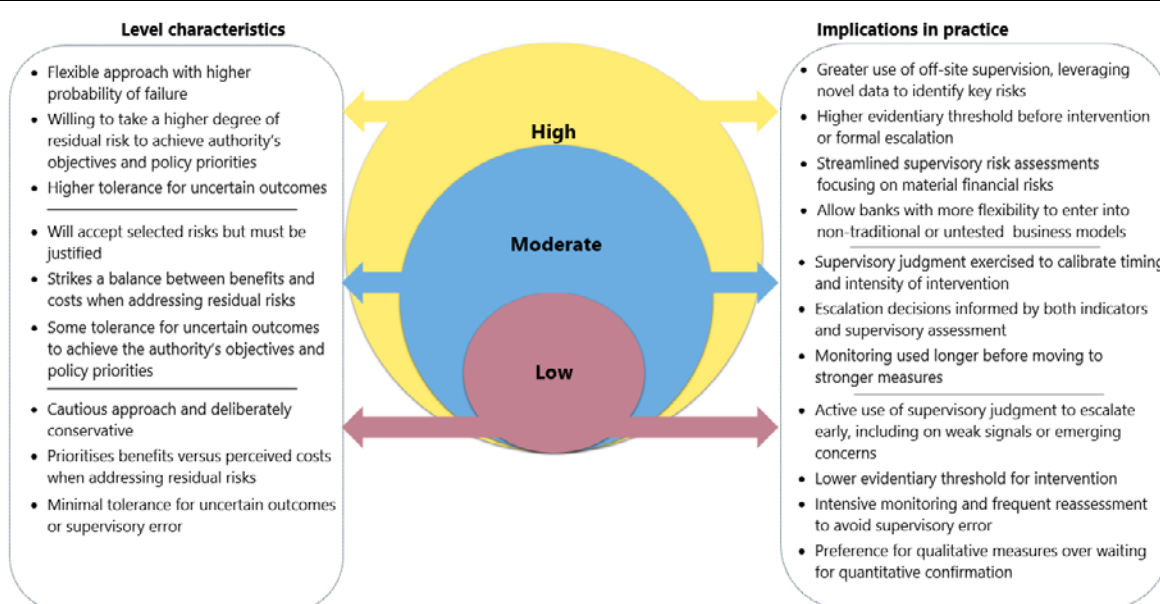
61. **The second step involves establishing and defining the risk tolerance scales that the SA will apply for the various risk types covered by the RAF.** As noted in Section 3, the ECB/SSM and OSFI use three-point and four-point scales, respectively. When determining the appropriate number of levels for a risk tolerance scale, it is important to strike a balance: the scale should provide sufficient range to differentiate between levels of risk tolerance without being so overly granular that it becomes difficult to implement in practice. In short, the approach taken should be similar to the criteria used by the SA in establishing the appropriate number/level of rating scales that are used for supervisory ratings assigned to banks.

62. **For purposes of the stylised example, Graph 4 introduces a three-point (high, moderate and low) risk tolerance scale and provides qualitative definitions for each level.** These definitions serve as the foundation for determining the SA’s overall tolerance for supervisory risk, as well as its subcomponents. Each rating definition is accompanied by a description (right-hand column) outlining the practical implications of being placed in a particular rating category.

63. **It is crucial that the selected risk tolerance scales align with SA leadership’s overall supervisory stance.** At one end of the spectrum, an SA with a high supervisory risk tolerance – perhaps due to severe resource constraints – consciously accepts a higher degree of residual risk and a greater tolerance for uncertain prudential outcomes, among other issues. In practice, this could mean relying heavily on off-site supervision rather than more labour-intensive on-site inspections to oversee firms. Under this approach, on-site supervision, when undertaken, may also be more streamlined to focus solely on financial risks, with the understanding that some risks may be overlooked, including risks which, in hindsight, could have a material impact on the firm’s safety and soundness. At the other end of the spectrum, an SA with a low supervisory risk tolerance adopts a more conservative supervisory approach, with minimal tolerance for uncertain outcomes. This could translate into an active use of supervisory judgment to intervene in banks at an early stage, well before breaches of quantitative thresholds occur. It could also mean greater intensity and frequency of supervisory activities to reduce the likelihood of missing material risks.

Supervisory risk tolerance scales

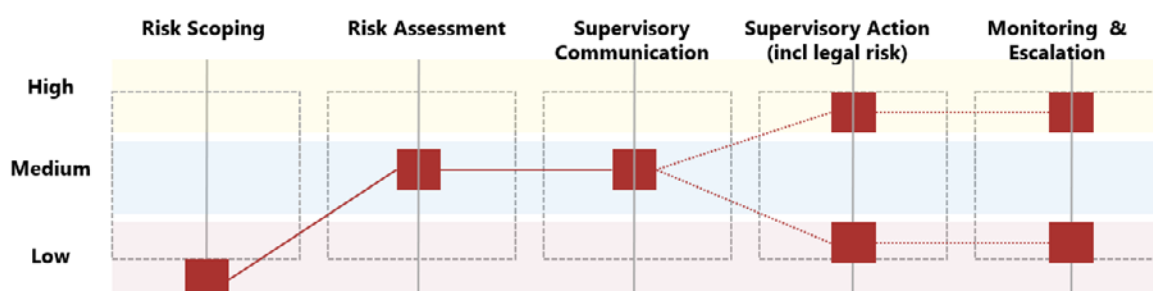
Graph 4



64. **Supervisory risk evolves across the supervisory cycle; as a result, an SA may adopt different tolerances at different stages without undermining the consistency of its overall stance.** Graph 5 illustrates one possible supervisory pathway for a systemically important institution, highlighting how differentiated risk appetites may apply across the supervisory cycle even where the SA adopts an overall conservative approach to managing supervisory risk.

- At the risk scoping stage, a low risk appetite reflects limited tolerance for blind spots or delayed identification of material risks, leading to conservative selection of key risk areas for in-depth assessment. This is particularly relevant for systemically important institutions, where the costs of missed risks are high.
- During risk assessment and supervisory communication, SAs may apply a moderate risk appetite, recognising that assessments increasingly rely on a combination of quantitative indicators and qualitative judgment. At this stage, SAs may accept a degree of uncertainty inherent in forward-looking analysis and graduated communication tools.
- At the stage of supervisory action, Graph 5 deliberately shows two alternative but internally consistent paths. Supervisory risk appetite is not static; it interacts with legal-litigation risk tolerance to shape escalation paths. One path reflects an SA that has minimal tolerance for uncertain legal outcomes (eg low appetite for litigation risk) and therefore relies on stronger evidentiary thresholds, informal actions and more cautious escalation.⁹ The alternative path reflects a higher tolerance for uncertain outcomes if supervisory actions are challenged in courts (eg high appetite for litigation risk), where the SA is willing to accept greater legal uncertainty in order to intervene earlier or more forcefully. The interventionist stance may also reflect the SA's obligation to act early, consistent with its mandate and relevant powers (with potential consequences for failing to act early in line with applicable laws and mandates).
- Informal supervisory actions sit between assessment and formal intervention and are used along both paths, with their role and sequencing shaped by the interaction between the SA's appetite for early intervention and its tolerance for legal risk. SAs with a high appetite for early intervention and higher tolerance for legal-litigation risk may rely on both formal and informal measures at an earlier stage. By contrast, SAs with high appetite for early intervention but low legal-litigation risk appetite may use informal actions more actively to influence behaviour, reserving formal escalation for elevated stages of breach or more severe identified weaknesses.
- In both cases, monitoring and escalation remain active throughout the cycle but are calibrated differently in terms of timing, intensity and legal robustness, reflecting distinct combinations of early intervention and legal risk appetites.

⁹ In this example, if the SA was also reticent to take informal actions without strong evidentiary thresholds being met due to its limited tolerance for uncertain legal outcomes, it would no longer be consistent with an overall conservative (low-risk) approach to managing supervisory risk for systemically important banks. In such a configuration, caution toward legal risk would effectively increase supervisory risk by delaying early influence and corrective action.



Step 3 – Formulate risk appetite statement(s)

65. **One of the most challenging – and arguably most critical – aspects of the RAF is the ability of the SA to clearly and realistically articulate its tolerance for supervisory risk.** Developing a RAS requires SA leadership to conduct an honest stocktake of both internal factors (eg areas within the SA’s control) and external influences (eg areas outside the SA’s control) that shape its overall appetite for supervisory risk. This stocktake should also involve input from line supervisory functions. This is particularly important given that an SA’s tolerance for supervisory risk is not static; it evolves in response to changes in internal and external factors.

66. **Against this background, Boxes 2 and 3 below present a hypothetical supervisory RAS for an SA operating under relatively significant resource constraints and with an early intervention mandate to preserve financial stability.** It covers two key components: (i) a statement on RBS as the foundation of its supervisory approach, outlining its focus on material risks and empowering supervisors to exercise judgment (Box 2); and (ii) its RAS, covering its overall tolerance for supervisory risk as well as specific RAS for key aspects of supervisory risk, including risk scoping, risk assessment, supervisory communication, supervisory actions and monitoring and escalation (Box 3).

67. **Boxes 2 and 3 need to be viewed in tandem as they provide a comprehensive framework for how the SA balances its early intervention mandate with resource constraints.** Box 2 acknowledges the trade-offs inherent in adopting RBS within a resource-constrained environment and highlights the importance of prioritising risks to ensure that supervisory efforts are focused on areas of greatest impact. It also underscores the critical role of SA leadership in fostering a proactive and judgment-driven supervisory culture. Similarly, the RAS outlined in Box 3 reinforces the importance of risk prioritisation and the exercise of supervisory judgment in achieving early intervention objectives. By explicitly linking its supervisory risk appetite – both overall and across its subcomponents – to its mandate and to internal/external factors, the SA aims to provide stakeholders with a clear understanding of the rationale behind its supervisory approach and the trade-offs involved to achieve its objectives.

68. **In articulating their RAS, SAs may also need to clarify how legal risk interacts with supervisory risk.** Legal considerations can influence the timing, intensity and form of supervisory intervention, particularly where actions may be subject to legal challenge. In practice, SAs may adopt different degrees of tolerance for legal-litigation risk. Some may exhibit low tolerance for delaying supervisory action solely due to concerns about legal challenge, emphasising the primacy of prudential objectives and early intervention. Others may recognise a moderate level of legal-litigation risk as an inherent feature of supervisory decision-making, accepting that well-grounded supervisory judgments

may occasionally be contested. In certain circumstances, SAs may demonstrate a higher tolerance for legal uncertainty where early and decisive intervention is necessary to address emerging threats to safety and soundness.

69. **All SAs need to carefully balance the public and private aspects of their RAS.** High-level aspects of the RAS – such as statements on RBS and the SA’s overall appetite for supervisory risk, including applicable definitions – may be suitable for public disclosure. Such disclosures can provide stakeholders, including market watchdogs, with insights on the SA’s overall approach to supervision and the trade-offs involved in fulfilling its mandate. However, more detailed aspects of the RAS, such as lower-level RAS covering key aspects of the supervisory review process or internal risk indicators and assessment criteria that support RAF implementation, may require a more nuanced approach. These elements should be evaluated using a case by case approach, balancing the benefits of transparency with the potential risks associated with over-disclosure.

Box 2

Statement on risk-based supervision (stylised example)

In fulfilling its prudential mandate, the SA adopts an RBS approach to efficiently allocate scarce supervisory resources to risks and institutions that pose the greatest threat to the stability of the domestic banking system. The primary objective of RBS is to identify and address material weaknesses in firms’ governance, risk management or business models **before** the effects of such shortcomings have an impact on a firm’s financial resilience.

Under the RBS approach and given resource constraints, the SA recognises that it cannot assess all risks simultaneously or with the same intensity. Supervisory teams are therefore empowered to exercise judgment regarding the scope and frequency of supervisory activities to be assessed at regulated entities, focusing on critical risk areas that require the greatest supervisory attention. This includes identifying risks that are judged to be either “low” or “well managed”, which can be deprioritised and deferred in order to allow for greater resources for pressing concerns, subject to the baseline supervisory activities required during the supervisory cycle. By focusing on the most significant risks, the SA can not only manage resources more efficiently but also minimise unnecessary costs to firms and the SA.

SA leadership acknowledges that supervisors may not – and are not expected to – identify every issue at every bank. SA leadership fully supports the risk-based decisions of supervisory teams and recognises that these decisions are made with the best available information and may, in hindsight, prove to be incorrect. The SA is committed to fostering a culture that encourages reasoned risk-taking and sound judgment. Leadership remains accountable for promoting and upholding this culture, supporting supervisors’ efforts to focus on the most critical risks to individual banks and the broader banking system.

Source: FSI staff analysis.

Risk appetite statements (stylised example)

Overall supervisory risk tolerance: The SA's overall tolerance for supervisory risk is **moderate**.

Tolerance for aspects of supervisory risk:

- Risk scoping
 - The SA has a **low risk tolerance** for failing to identify or prioritise material risks at large institutions.
 - The SA has a **moderate risk tolerance** for missing/not prioritising material risks at smaller institutions.
 - The SA has a **high risk tolerance** for deprioritising risks that are deemed immaterial or well managed by regulated entities, provided this judgment is documented and subject to periodic review.
- Risk assessment
 - The SA has a **low risk tolerance** for inaccurate or unsupported supervisory rating decisions at large banks and for the persistence of weak ratings assigned to these institutions' governance or overall ratings.
 - The SA has a **moderate risk tolerance** for imprecise supervisory rating decisions as a by-product of risk-based scoping decisions taken at smaller institutions.
 - The SA has a **high risk tolerance** for less frequent or lighter-touch inspections for smaller banks that are judged to be well managed and with good composite supervisory ratings.
- Supervisory communication
 - The SA has a **low risk tolerance** for not prioritising and poorly communicating material supervisory findings in supervisory inspection reports and/or letters to the firm's board.
 - The SA has a **moderate risk tolerance** for supervisory guidance (issued to the industry) that does not clarify the SA's expectations or that is open to misinterpretation by firms.
 - The SA has a **high risk tolerance** for omitting less material supervisory findings in formal communication to banks, such as supervisory inspection reports.
- Supervisory actions^①
 - The SA has a **low risk tolerance** for supervisory actions that fail to address the root cause of identified problems and for the inconsistent use of moral suasion to address supervisory findings in banks.
 - The SA has a **moderate risk tolerance** for using informal escalation tools before resorting to formal enforcement actions.
 - The SA has a **high risk tolerance** for early intervention, including a willingness to take banks to court to enforce its actions.
- Monitoring and escalation
 - The SA has a **low risk tolerance** for failing to escalate repeat or unresolved material findings at the same institution.
 - The SA has a **moderate risk tolerance** for delays in resolving findings at smaller institutions, provided these findings do not pose systemic risks.
 - The SA has a **high risk tolerance** for less frequent follow-up for non-material findings.

^① The SA's stance on supervisory actions is the direct result of its stated tolerance for legal-litigation risk, which, as discussed earlier, is a subset of a firm's overall supervisory risk tolerance. In general, a high legal-litigation risk appetite is compatible with taking timely supervisory actions, while a low legal-litigation risk appetite may conflict with the expectations in the Core Principles for Effective Banking Supervision (BCPs) for supervisors to take timely actions. See (BCBS (2024)), BCP 11 for further details.

Source: FSI staff analysis.

Step 4 – Operationalising risk appetite in the supervisory process

70. **The development of relevant qualitative and quantitative risk indicators is essential to bridge the gap between defining supervisory risk appetite and operationalising it.** The selected risk indicators should align with the SA's stated supervisory risk tolerance and cover key aspects of the supervisory review process, including risk scoping, risk assessment, supervisory actions, communication and monitoring and escalation. While the supervisory RAS is articulated in qualitative terms, the risk indicators should encompass qualitative and quantitative elements where possible. This approach enhances the practical application of the RAS across supervisory teams and enables ongoing monitoring of the SA's risk tolerance.

71. **Defining effective supervision adds complexity to the development of appropriate risk appetite indicators.** Unlike financial institutions, where many risks can often be quantified and measured against clear financial outcomes, SAs operate in a domain in which success is harder to define and measure. Supervisory effectiveness depends on qualitative judgments such as the sufficiency of oversight, the nature and timeliness of interventions and adaptability to changing circumstances, all of which are difficult to quantify.¹⁰ This lack of quantifiable benchmarks increases reliance on qualitative risk indicators, adding a layer of complexity to the supervisory RAF.

72. **Table 4 provides a stylised example of how qualitative RAS can be translated into day-to-day supervisory practices.** These examples demonstrate how an SA can integrate its stated risk tolerances into specific operational guidelines across key elements of the supervisory process. For instance, in the area of risk scoping, the SA prescribes baseline coverage/scoping requirements for large institutions. This increases the likelihood that material risks are identified and key governance functions are assessed, aligning with the SA's low risk tolerance for failing to identify material risks at large institutions. In contrast, the SA allows supervisory teams of smaller banks full discretion to defer review of certain risk areas based on their judgment (eg if deemed immaterial or well managed). While this discretionary approach increases the possibility that material risks are missed, the SA has deliberately accepted this trade-off, reflecting its moderate risk tolerance for such occurrences at smaller banks. In short, these risk metrics reflect the SA's differing risk tolerance levels for larger versus smaller banks, while supporting its risk-based supervisory approach.

¹⁰ The BCBS defines effective supervision as one that "promotes the safety and soundness of banks and the banking system by promptly assessing prudential risks, identifying material shortcomings within banks and using the supervisory toolkit and powers appropriately to ensure that banks remediate shortcomings in a timely manner" (Badev et al (2025)).

Stylised example of linking risk appetite, indicators/measures and consequences

Table 4

Element	Risk tolerance	Potential risk indicators, measures and assessment criteria	Consequences in case of breach
Risk scoping	Low risk tolerance for failing to identify material risks at large institutions	<ul style="list-style-type: none"> • Prescribed baseline coverage: all critical risk areas reviewed within the cycle; non-critical risks subject to periodic rotation • Minimum depth requirements for material financial risks (eg transaction testing) • Mandatory in-depth reviews of governance and risk management functions • Signal-to-scope responsiveness: ability to adjust scoping decisions promptly in response to emerging risk indicators 	<ul style="list-style-type: none"> • Mandatory senior management review of scoping • Targeted review of scoping practices • Feedback into supervisory planning, including potential reallocation of specialist resources
	Moderate risk tolerance for missing material risks at smaller institutions	<ul style="list-style-type: none"> • Full flexibility in determining areas of coverage, subject to explicit justification for excluded risks • Peer analysis in scoping choices across institution clusters • Ex post identification rate: frequency with which material risks emerge outside the planned scope 	<ul style="list-style-type: none"> • Temporary narrowing of flexibility in the case of high ex post identification rate for a supervisory team • Horizontal review if material risks are repeatedly missed
	High risk tolerance for deprioritising risks that are assessed to be immaterial or well managed	<ul style="list-style-type: none"> • Duration for which specific risk areas remain out of scope • Concentration of long deferrals across risk types or institutions 	<ul style="list-style-type: none"> • Mandatory senior sign-off once deferral exceeds an agreed period • Automatic re-inclusion of the risk in scope after all deferral deadlines are exhausted

Element	Risk tolerance	Potential risk indicators, measures and assessment criteria	Consequences in case of breach
Risk assessment	Low risk tolerance for inaccurate or unsupported supervisory ratings at large banks and for the persistence of weak ratings assigned to them	<ul style="list-style-type: none"> Percentage of supervisory ratings of large firms revised or overturned during quality assurance reviews, categorised by cause, ensuring that the percentage remains below an acceptable threshold (eg below 5–10%) Predefined consequences for large banks with weak ratings persisting beyond X number of exam cycles (eg asset growth restrictions, merger and acquisition limitations) until the underlying issues are resolved and ratings improve Review of whether methodologies are still capturing the most material risks or if they are obsolete Supervisory team quality and independence indicators (experience and seniority mix, years assigned to the same bank and/or risk) Number of supervisory cycles during which ratings (especially weak ratings) remain unchanged without escalation or remediation 	<ul style="list-style-type: none"> Discussion of ratings changed via internal quality assurance processes in dedicated meetings with senior management Mandatory targeted training, rotation of responsibilities or reassignment of supervisory staff where deficiencies in judgment, experience or objectivity persist Automatic horizontal review of institutions with scores that are unchanged over the past years Resourcing decisions, team composition and methodological refinements informed by persistent issues
	Moderate risk tolerance for imprecise supervisory rating decisions as a by-product of risk-based scoping decisions taken at smaller institutions	<ul style="list-style-type: none"> Percentage of supervisory ratings for smaller firms revised or overturned during quality assurance reviews, categorised by cause, ensuring that the percentage remains below an acceptable threshold (eg 15–20%) 	<ul style="list-style-type: none"> Focused review of rating rationales and underlying assessments
	High risk tolerance for less frequent or limited-scope inspections for smaller banks with good supervisory ratings	<ul style="list-style-type: none"> Maximum deferral period (eg X years) for full-scope inspections of smaller banks with strong ratings (eg composite scores above X and governance ratings of “satisfactory” or higher) 	<ul style="list-style-type: none"> Requirement of explicit senior sign-off to continue limited assessment intensity beyond agreed thresholds Initiation of full-scope or targeted review once all deferral periods are reached

Element	Risk tolerance	Potential risk indicators, measures and assessment criteria	Consequences in case of breach
Communication	Low risk tolerance for not prioritising and poorly communicating material findings in supervisory inspection reports and/or letters to the firm's board	<ul style="list-style-type: none"> Requirement for supervisory communication to highlight no more than the top X concerns, prioritised by predefined criteria (eg risks to financial resilience, business model or governance), with other findings documented in an annex Supervisory report to the CEO, requiring supervisory dialog and individually assigned board members to mitigate communicated weaknesses Evidence that findings are accompanied by clear supervisory expectations and remediation timelines 	<ul style="list-style-type: none"> Mandatory training on effective supervisory communication for affected teams
	Moderate risk tolerance for supervisory guidance (issued to banks) that does not clarify the SA's supervisory expectations or that is open to misinterpretation	<ul style="list-style-type: none"> Stipulation that all supervisory guidance issued to the industry must be reviewed within a specified time period Requirement for periodic surveys of regulated entities, which must show that at least X% of respondents find the guidance clear and actionable 	<ul style="list-style-type: none"> Guidance identified as unclear is not used as a basis for supervisory assessment until clarified Issuance of clarifying notes, FAQs or supervisory statements to address identified ambiguities
	High risk tolerance for omitting less material supervisory findings in formal communication to banks, such as supervisory inspection reports	<ul style="list-style-type: none"> Requirement for at least X% of supervisory inspection reports to include only material findings, as defined by the SA's materiality criteria; all less material findings must be documented separately for internal monitoring, with less than X% requiring escalation within 12 months due to changes in materiality or risk profile 	<ul style="list-style-type: none"> Thematic assessment of communication and materiality practices in the case of systematic issues

Element	Risk tolerance	Potential risk indicators, measures and assessment criteria	Consequences in case of breach
Informal and formal actions	Low tolerance for supervisory actions that fail to address the root cause of problems and for the inconsistent use of moral suasion to address supervisory findings in banks	<ul style="list-style-type: none"> Requirement for all supervisory actions to include a documented root cause analysis, linking the action to the underlying issue Outline in the supervisory manual explaining when moral suasion versus other informal supervisory actions should be utilised Monitoring of the use of qualitative measures Frequency with which the same or closely related issues recur after supervisory action has been taken 	<ul style="list-style-type: none"> Escalation of supervisory actions that are delayed, poorly aligned to root causes or repeatedly ineffective (as identified by quality assurance) to senior supervisory management for review Temporary limitation on the use of moral suasion if an institution has repeat or overdue findings Automatic re-scoping of the relevant risk area and increased supervisory intensity where root cause issues persist
	Moderate tolerance for using informal escalation tools before resorting to formal enforcement actions	<ul style="list-style-type: none"> Establishment of links between firms' composite ratings and preference for informal actions (eg under a supervisory rating scale from 1 to 5, 1- and 2-rated firms should generally be subject to informal actions unless there are unusual circumstances involved) Share of issues addressed through informal actions that are resolved within the expected time frame without escalation to formal enforcement Speed with which unresolved issues are escalated from informal to formal measures 	<ul style="list-style-type: none"> Targeted training or peer calibration exercises where inconsistent use of informal tools is identified Use of horizontal analysis among supervisory teams' results to update supervisory manuals to clarify when informal tools should give way to formal enforcement
	High tolerance for early intervention, including a willingness to take banks to court to enforce actions	<ul style="list-style-type: none"> Requirement for supervisors to act (formally or informally) to address qualitative weaknesses even if the firm's financial resilience metrics meet or exceed regulatory requirements Requirement for at least X% of material issues to be addressed through early intervention (formal or informal) within X time period of identification Establishment of links between composite ratings assigned to a firm and use of legally binding formal actions (eg under a supervisory rating scale from 1 to 5, firms rated 3 or worse or 2-rated firms with material repeat findings are expected to be subject to formal actions) Frequency with which unresolved early interventions progress from informal to formal and, where necessary, to legally enforceable actions 	<ul style="list-style-type: none"> Senior management review triggered by failure to initiate early intervention for material qualitative weaknesses Review of supervisory practices by quality assurance teams triggered by recurrent reluctance to escalate or litigate Use of lessons from legal challenges used to update supervisory manuals, escalation guidance and training

Step 5 – Governance arrangements

73. **Clear senior management ownership is required to anchor the framework in the SA's mandate and strategic priorities.** More concretely, senior management formally approves the RAF, sets the overall tolerance for supervisory risk and remains accountable for the trade-offs implied by RBS. This includes explicit recognition that prioritisation choices – such as accepting greater uncertainty in some areas while insisting on early intervention in others – are institutional decisions rather than discretionary choices made by individual supervisors. In practice, this may be reflected in senior management endorsement of supervisory planning priorities, periodic review of material deviations from the stated risk appetite and explicit backing of supervisors where well-reasoned judgments taken in line with the RAF lead to imperfect or contested outcomes.

74. **To support consistent application, the framework should be reinforced by an independent second line function with a clear mandate to oversee the use of supervisory risk appetite.** Positioned outside front line supervision, this function monitors how risk appetite is interpreted across supervisory teams, conducts cross-team benchmarking and thematic reviews and challenges patterns of excessive conservatism or undue risk-taking. Importantly, unlike quality assurance teams that may often operate after supervisory decisions are taken, the second line function in a formalised RAF should be actively involved during the supervisory process, providing real-time challenge and oversight. This proactive involvement reinforces accountability and helps prevent over-reliance on individual supervisory judgment.

75. **To enable effective oversight, the second line should develop and maintain senior management-level dashboards that synthesise key supervisory risk indicators across the supervisory cycle.** These dashboards should focus on directional trends, limit breaches and escalation patterns. To perform this role credibly, the stature of the second line should be commensurate with that of line supervision, and its reporting lines should be independent from those responsible for day-to-day supervisory decisions.

76. **Governance arrangements should also explicitly protect the exercise of supervisory judgment within clearly defined guardrails.** For example, supervisors are expected to apply discretion, particularly where information is incomplete or forward-looking. Judgments that align with the stated risk appetite and are properly documented, must be supported ex post, even where outcomes are uncertain or contested. This protection is critical to encourage the use of discretion and to avoid box-ticking behaviour.

77. **The RAF should incorporate structured feedback loops and periodic reviews to ensure that it remains effective and relevant over time.** Feedback may draw on supervisory outcomes, enforcement experience, internal reviews, audit findings or lessons learned from episodes of supervisory stress. Changes in the external environment – such as legal developments, shifts in policy priorities or emerging risks – should also inform recalibration.

78. **As a result, supervisory risk appetite is not static; it evolves over time.** In practice, SAs may recalibrate their tolerance across risk areas, introducing a modular dimension to the RAF whereby supervisory intensity and tolerance are dynamically adjusted rather than applied uniformly. For example, during periods of heightened concern, an SA may adopt a lower tolerance for supervisory risk in specific areas while accepting higher tolerance in less material areas. As risks are addressed and supervisory confidence increases, this calibration can shift accordingly, ensuring that the RAF remains forward-looking, adaptive and aligned with the most pressing risks.

Section 5 – Conclusions

79. **When adapted to the supervisory context, RAFs can strengthen the culture of SAs and improve their overall effectiveness.** While not a magic bullet, RAFs can align strategic goals with supervisory practices and provide structure and consistency around the use of supervisory judgment, a fundamental element in making risk-based decisions under varying conditions throughout the supervisory review process.

80. **A key benefit of introducing a formalised RAF is its potential to strengthen governance and accountability within SAs.** While informal frameworks can also be effective in guiding day-to-day supervision, they can also leave critical decisions – such as prioritisation/risk scoping, escalation and intervention – in the hands of individual supervisors without the necessary guardrails. A formalised RAF provides a structured approach to ensure that these decisions are aligned with the SA's strategic objectives and supervisory risk appetite. It also establishes clear roles and responsibilities, including the importance of an independent second line of defence to challenge and monitor supervisory decisions, ideally in real time.

81. **SAs seeking to introduce RAFs could consider five interconnected elements, tailored to their jurisdiction-specific internal factors and external environment in which supervision operates.** These components include: (i) defining supervisory risk and other relevant risk taxonomies covered by the RAF; (ii) formulating risk appetite scales; (iii) developing RAS; (iv) introducing qualitative and quantitative risk indicators to operationalise the RAS; and (v) establishing effective governance arrangements, including an independent second line function. Together, these steps create a virtuous cycle in which RAFs reinforce a strong supervisory risk culture while relying on strong governance and culture for effective implementation.

82. **There may be scope for standard-setting bodies to support the adoption of supervisory RAFs.** This could include developing a globally harmonised definition for supervisory risk. It could also involve prescribing essential and/or additional criteria in the BCPs to set minimum standards for supervisory RAFs that are tailored for the safety and soundness mandate of SAs.

83. **Beyond strengthening SAs' governance and culture, RAFs provide transparency around the trade-offs inherent in supervision, particularly as risk appetite shifts in response to internal or external factors.** At one end of the spectrum, supervision can take a more assertive posture, vigorously pursuing a safety and soundness mandate. At the other end, it can be recalibrated as a shield or protection mechanism to reflect a broad range of internal or external constraints (eg if legislative bodies encourage SAs to increase their supervisory risk appetite to facilitate broader growth objectives). These shifts highlight both the immense power and malleability of supervision (Conti-Brown and Vanatta (2025)). Regardless of its posture, a well-designed RAF ensures that stakeholders – including policymakers and the political class – are fully informed of the risks accepted in pursuit of the SA's prudential objectives.

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