

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,

¹ Raihan Zamil, Bank for International Settlements (raihan.zamil@bis.org) and Monica Adina Balan, European Central Bank (Monica-Adina.Balan@ecb.europa.eu). The authors would like to thank senior officials from OSFI and the ECB for sharing their approaches, Andrea Enria and Michael Hsu for helpful comments and Charlotte Gardini for administrative support.

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.