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Act early or pay later: the role of qualitative measures in effective supervisory frameworks

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Executive summary

The March 2023 banking turmoil, the most significant banking sector stress since the Great Financial Crisis (GFC), highlighted deficiencies in the quality of bank governance practices and the effectiveness of supervision. While the ensuing bank failures were triggered by liquidity runs, the root causes were poor board oversight, flawed risk management and/or unsustainable business models in banks ("qualitative weaknesses"). The subsequent post-mortem reports also pointed to failures in supervision and, in particular, delays in taking timely actions, which allowed lax risk management and unsustainable business models to continue until they eventually manifested in a liquidity crisis.

The turmoil also served as a powerful reminder that no amount of quantitative requirements can compensate for banks' qualitative weaknesses. It demonstrated that banks can comply with capital and liquidity requirements and still face a crisis of confidence. This underscores the critical importance of supervisors identifying and addressing the nature and severity of qualitative weaknesses in banks in a timely manner.

Yet, taking timely qualitative measures poses challenges for supervisors due to various institutional, legal and supervisory constraints. While some obstacles – like institutional and legislative issues – are beyond their control, many relate to aspects within their purview. These include the adequacy of supervisory tools and techniques that underpin risk assessments, communication of findings, internal processes like monitoring and escalation, and staff expertise.

In all jurisdictions, the effective use of qualitative measures depends on the robust application of a chain of related yet distinct supervisory activities that comprise the supervisory process. These include risk scoping, risk assessment, supervisory actions, communication, and monitoring and escalation. How each step is implemented significantly influences the decision to impose qualitative measures, as well as their type and severity. Implementation of each step is guided by: (i) jurisdiction-specific tools, rating systems, methodologies, guidance and processes; and (ii) the expertise and gravitas of supervisory teams, including their ability to exercise judgment on complex qualitative issues.

While the supervisory process aims to address banks' risks and vulnerabilities, methodologies and approaches differ across sampled jurisdictions. Risk assessment methodologies differ in design, covering various risk areas and using different scoring systems with varying degrees of prescription. These differences can affect the application of qualitative measures. Surveyed authorities have access to most – but not the full range of – qualitative measures, using informal and formal instruments, with moral suasion frequently used to address qualitative weaknesses at an early stage. Some authorities differentiate the severity of actions using a single instrument with variations in tone and signatory, while others employ multiple instruments. Written communication tools vary, with many shifting to streamlined approaches that highlight key risk areas. For escalation, some rely heavily on supervisory team judgments, while others have documented procedures to foster consistency.

To future-proof supervision, a range of initiatives focused on enhancing the use and effectiveness of qualitative measures can be considered. The initiatives noted below (and detailed in Section 7) address each element of the supervisory process, drawing from specific features in sampled

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jurisdictions' supervisory frameworks and the authors' own analysis. There is no "quick fix" in enhancing supervision; depending on jurisdiction-specific circumstances, actions may be required on multiple fronts to address the factors that influence supervisors' ability and will to act.

- **Risk scoping:** Risk scoping defines areas to allocate resources, influencing the depth and focus of supervisory assessments and shaping the scope and severity of findings. Authorities may benefit from defining their own risk appetite framework in order to clarify the level of risk they are willing to assume when supervisors make risk-based decisions in the risk scoping process. Using top-down and bottom-up approaches in risk scoping – with appropriate safeguards for the latter – can enhance the risk scoping process.
- **Risk assessment and rating system design**: Risk assessments, including the use of qualitative measures, are framed by jurisdictional choices on the design of risk rating systems. Authorities may consider evaluating and, if needed, enhancing certain features of their rating systems to facilitate the prompt identification of qualitative weaknesses in banks. Key areas to consider include placing greater emphasis on qualitative elements in order to influence the overall rating assigned to a firm by: (i) adopting a "weakest link" approach, under which a poor rating in any component drives the overall rating, ensuring that qualitative weaknesses are not overshadowed by stronger scores in other areas; (ii) elevating the importance of the governance rating such that the rating assigned for this component guides the overall composite rating assigned to a firm; and (iii) introducing an explicit stand-alone rating for business model viability.
- **Risk assessment of governance and business models:** Tools for governance and business model assessments are critical in helping to detect qualitative weaknesses before they surface in banks' financial metrics. Developing "red flags" or other indicators can help supervisors identify shortcomings at an early stage. Additionally, individual accountability regimes (IARs) can make it easier for supervisors to hold senior officials accountable for failings that occur under their watch.
- **Supervisory actions:** Supervisors have latitude in selecting actions to resolve deficiencies, though some authorities may need legislative action to access the full suite of qualitative measures. Successful qualitative provisions identified in several jurisdictions include: (i) assigning responsibility for overseeing corrective actions to senior-level individuals or board subcommittees to foster accountability; and (ii) replacing key senior officials and imposing business restrictions to drive cultural and strategic change where needed. Differentiating the severity of qualitative findings, such as by providing two-way links between ratings and actions, enhances effectiveness. Additionally, developing guidance on a menu of options for identifying and addressing business model weaknesses and clarifying when to use moral suasion versus other informal actions can further aid supervisors.
- **Supervisory communication, monitoring and escalation:** Communication bridges the gap between identifying weaknesses and implementing corrective measures. Authorities could consider issuing a consolidated letter at the end of the supervisory cycle that integrates findings from various supervisory engagements, prioritises key concerns and outlines remediation steps and timelines that provide clear guidance to firms. Disclosing supervisory risk ratings to banks, including the definitions of each rating level, provides greater clarity on the steps needed for banks to improve their risk ratings and helps firms benchmark their performance against regulatory expectations. Robust IT systems are essential to support supervisory monitoring of corrective actions, while structured escalation procedures that increase the severity of actions when banks fail to address identified deficiencies can provide consistency in decision-making.

Above all, supervisory judgment is the "glue" that binds the entire supervisory process. All authorities face the age-old tension between rules and discretion in supervision, and they need to find the right mix between fostering judgment and providing sufficient guidance to support supervisory decisions that align with their risk appetite framework and jurisdiction-specific needs.

Section 1 – Introduction

1. **The March 2023 banking turmoil is the latest chapter in periodic episodes of banking sector distress, highlighting weaknesses in banks' corporate governance practices and the sustainability of their business models.** The proximate cause of all bank failures stems from capital or liquidity insolvency; the root causes, however, invariably point to breakdowns in bank governance and risk management practices, which are often accompanied by flawed business models and poor risk culture (hereafter collectively referred to as "qualitative weaknesses"). In many cases, these shortcomings may be initially obscured by favourable financial market tailwinds, allowing even poorly managed banks to report superior financial results and to meet or exceed applicable capital and liquidity requirements. Under such circumstances, weak risk management practices and unsustainable business models can continue to persist – in the absence of supervisory intervention – until they eventually surface and begin to affect the firm's financial soundness.

2. **It also exposed gaps in supervision.** Following the March 2023 banking turmoil, the ensuing post-mortem reports – in addition to laying primary responsibility on bank boards and senior management – revealed shortcomings in supervision; and, more specifically, the (in)ability of supervisors to take sufficiently timely actions – in particular, qualitative measures – to ensure prompt remediation by banks (BCBS (2023)). They also revealed that banks can meet all quantitative requirements and still be on the verge of failure, especially if there are broader shortcomings in governance and/or business model sustainability (FINMA (2023)).

3. **These developments underscore supervisory challenges in taking timely qualitative actions.** Nearly all problems in banks initially manifest in the form of qualitative weaknesses; and if supervision fails to promptly identify and address those weaknesses, they can lead to more severe consequences for banks and the financial system, as demonstrated by the most recent turmoil.[2] Yet, supervisors face obstacles in taking early action, especially when a bank's financial condition remains sound. This is partly because the process of identifying the nature and severity of qualitative weaknesses and how aggressively to pursue corrective actions requires nuanced supervisory judgment (Zamil (2010)) and is premised on a broader range of institutional factors.

4. **Effective qualitative measures rely on a strong institutional setting and the existence of certain prerequisites, some of which are beyond the control of supervisory authorities.** In a recent report, the International Monetary Fund (IMF) observed that several advanced and emerging economies face weaknesses in their operational independence, supervisory mandates, supervisory powers and the adequacy of supervisory resources (Adrian et al (2023)).

5. **There are, however, other factors that influence supervisors' capacity to act that are largely within the purview of supervisory authorities.** These elements include but are not limited to: (i) the adequacy of tools and methodologies that support supervisory planning, risk assessments and related supervisory actions; (ii) the approaches supervisors use to communicate findings to banks; and (iii) escalation procedures and monitoring. Ultimately, the effectiveness of these approaches hinges on the governance and culture of the supervisory authority and the resourcing and expertise of frontline supervisory staff, including their capacity to exercise judgment (Carstens (2023)).

6. **To enhance the quality of supervision, the Basel Committee on Banking Supervision (BCBS) recently updated its *Core principles for effective banking supervision (*BCPs).** The BCPs, which set the minimum global benchmark for the prudential supervision of banks, were published in April 2024, incorporating lessons from the March 2023 turmoil (BCBS (2024)). Among other items, the BCPs include

[2] In 2023, the European Central Bank (ECB) published the results of an external assessment of its supervisory process, which included various recommendations to enhance the supervisory process. These recommendations included a key proposal to strengthen the links between supervisory risk assessments and the use of qualitative measures, as capital alone cannot address risks arising from weak governance practices and unsustainable business models. See Dahlgren et al (2023) for details.

enhancements to supervisory expectations for banks while raising the bar on supervisory practices. In regard to the latter, the revisions include an emphasis on the use (and not just the existence) of a wide range of tools for addressing unsafe and unsound practices in banks at an early stage (BCP 11), while providing greater focus on supervisory methodologies that assess the viability of bank business models (BCP 8).

7. **This paper examines the supervisory approaches that underpin the use of qualitative measures in selected jurisdictions and identifies key attributes that can enhance supervisory effectiveness.** For the purposes of this paper, qualitative measures are the instruments used by supervisors to directly address observed shortcomings in banks' governance, culture, risk management and/or business model sustainability. As such, it does not review/address the methods supervisors use to determine the need for additional quantitative requirements such as add-ons for capital and liquidity. The findings are based on a review of public information on supervisory authorities in eight jurisdictions[3] as well as investigative reports published by national authorities and international organisations on the March 2023 turmoil. Public information was supplemented with interviews from senior supervisors in nearly all sampled jurisdictions and the authors' own analysis.

8. **The rest of the paper is structured as follows:** Section 2 summarises the key challenges associated with taking early action, with a focus on those elements that are solely within the control of the supervisory authority. Section 3 provides an overview of the supervisory process, including how various stages of the supervisory cycle help to inform the need for qualitative actions. Section 4 takes stock of jurisdictional approaches to the planning and risk assessment aspects of the supervisory process, while Section 5 explores the supervisory actions that arise from the risk assessment phase, with a particular focus on qualitative measures. Section 6 covers the approaches authorities use to communicate supervisory findings to banks and outlines their monitoring and escalation procedures. Section 7 offers suggestions for enhancing supervisory practices, while Section 8 briefly concludes.

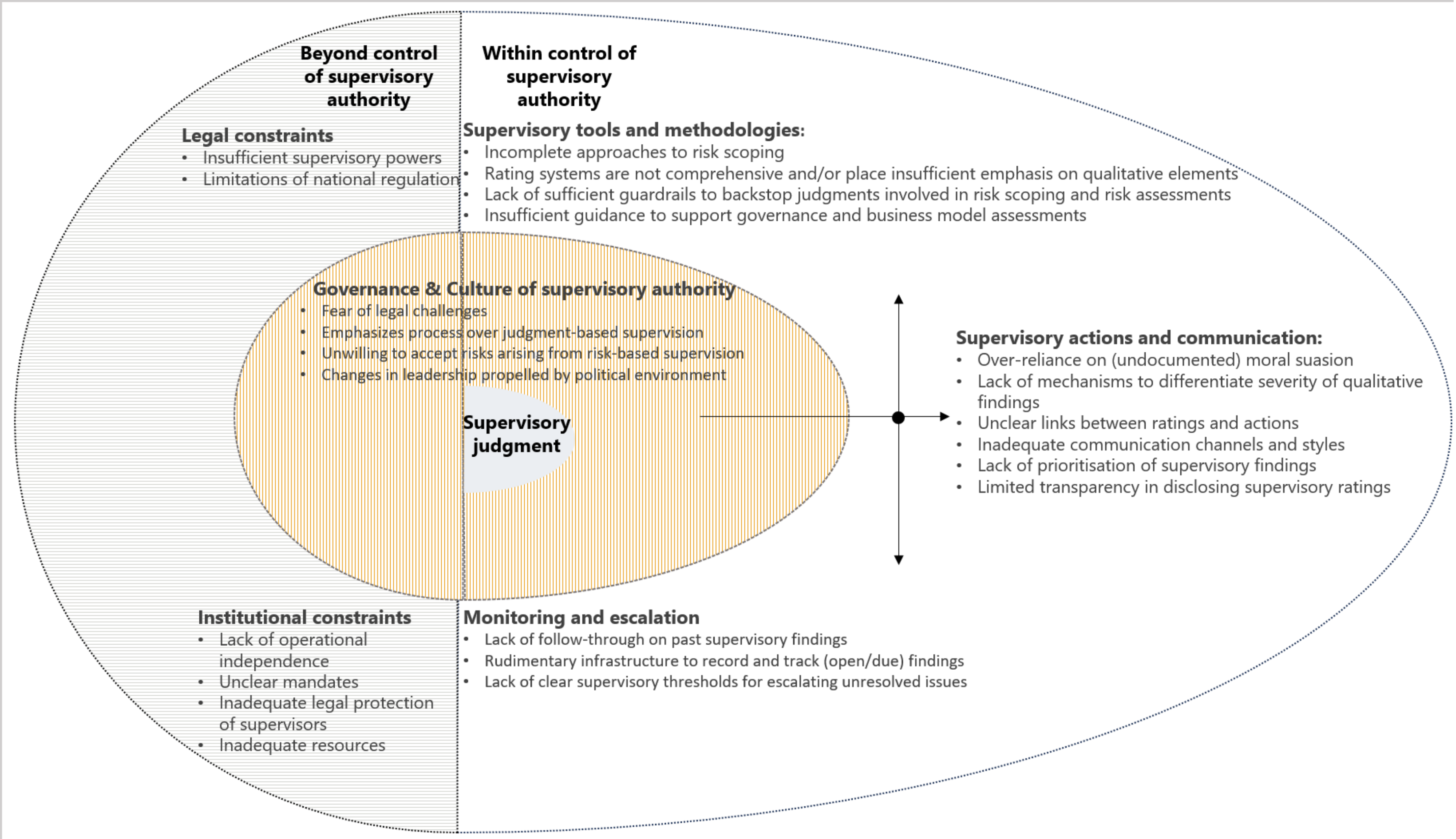
Section 2 – Supervisory challenges in taking early actions

9. **To varying degrees, all authorities face a broad range of institutional, legal, cultural and supervisory challenges in taking early actions.** The egg-like figure below (Graph 1) provides a non-exhaustive snapshot of the various factors that may hinder supervisors' ability and/or will to act. The constraints are organised based on factors that are beyond the control of the supervisory authority (shaded left side of egg shape) and those within its control (unshaded right side). These obstacles are not uniform across supervisory authorities and may vary based on jurisdiction-specific circumstances. While there is no single supervisory authority that faces no impediments, some authorities face more obstacles than others.

[3] These jurisdictions include Australia, Brazil, Canada, China, Singapore, the United Kingdom, the United States (eg the Board of Governors of the Federal Reserve System (FRB) and the Office of the Comptroller of the Currency (OCC)) and the European Union (eg countries that are part of the ECB's Single Supervisory Mechanism).

Roadblocks to early supervisory action

Graph 1



10. **Supervisory roadblocks refer to any shortcoming related to the supervisory toolkit and accompanying internal processes that are largely within the control of the supervisory authority.** These challenges are the focus of this paper and are classified into three main areas covering: (i) supervisory tools and methodologies that underpin the risk scoping and assessment process; (ii) supervisory actions and communication of findings; and (iii) monitoring and escalation. Depending on how each of these distinct but interrelated activities is designed and implemented in each jurisdiction, they can either facilitate or hinder supervisors' ability or will to act. For example, if supervisors fail to identify all material risks – including key risk control systems – during the risk scoping phase and/or inaccurately assess certain activities to be low-risk, they may not allocate sufficient resources during the risk assessment phase; this in turn may affect the nature of qualitative findings that require corrective measures. Moreover, the absence of clear escalation procedures when banks fail to comply with supervisory findings may lead to inconsistent approaches across supervisory teams and increase the likelihood that supervisory findings remain unresolved for an extended period.

11. **Institutional and legal constraints are outside the remit of the supervisory authority and beyond the scope of this paper, but can still affect supervisors' ability and will to act.** Based on its experience with assessing compliance with the BCPs in 45 countries from 2012 to 2021, the IMF found a number of weaknesses in institutional frameworks across advanced and emerging economies (Adrian et al (2023)). Its findings reveal that more than 80% of assessed jurisdictions do not have supervisors with sufficient operational independence, making them particularly vulnerable to political decisions/interference by national governments. In addition, more than half of assessed jurisdictions have tasked their respective supervisory authorities with multiple mandates, which can conflict with and/or distract from supervisors' core safety and soundness objective.[4] Other identified deficiencies include insufficient powers, inadequate resources[5] and inadequate legal protection for supervisors. These collective weaknesses can have a significant bearing on supervisors' ability and will to act early, and their remediation requires action by legislative bodies.

12. **Governance and culture of the supervisory authority straddle both categories but are not covered in this paper.** On the one hand, the "tone from the top" can either impede or foster supervisors' will to act, and the tone can change with changes in senior leadership of the supervisory authority, which may be precipitated by changes in the political environment (which are beyond the control of the supervisory authority). A supervisory authority's culture, however, is firmly within its control and comprises a broader set of values, beliefs and actions that take years to nurture, and culture cannot be completely modified with changes at the head of the supervisory authority.

13. **A common thread that cuts across all supervisory constraints and is a crucial element of a supervisory authority's governance and culture is the fundamental role of supervisory judgment.** If the leadership of the supervisory authority is not willing to accept the risks that accompany a judgment-based supervisory approach, frontline supervisors may be less willing to exercise judgment. Similarly, the application of supervisory tools and methodologies, communication of supervisory actions and findings, and monitoring and escalation procedures all involve various degrees of judgment. This in turn requires sufficient staff resources and expertise. In this sense, supervisory judgment can be thought of as the glue that binds the entire supervisory review process.

[4] See Kirakul et al (2021) for further discussion on the multiple mandates of banking supervisors.

[5] See Coelho and Guerra (2024) for further information on supervisory resources.

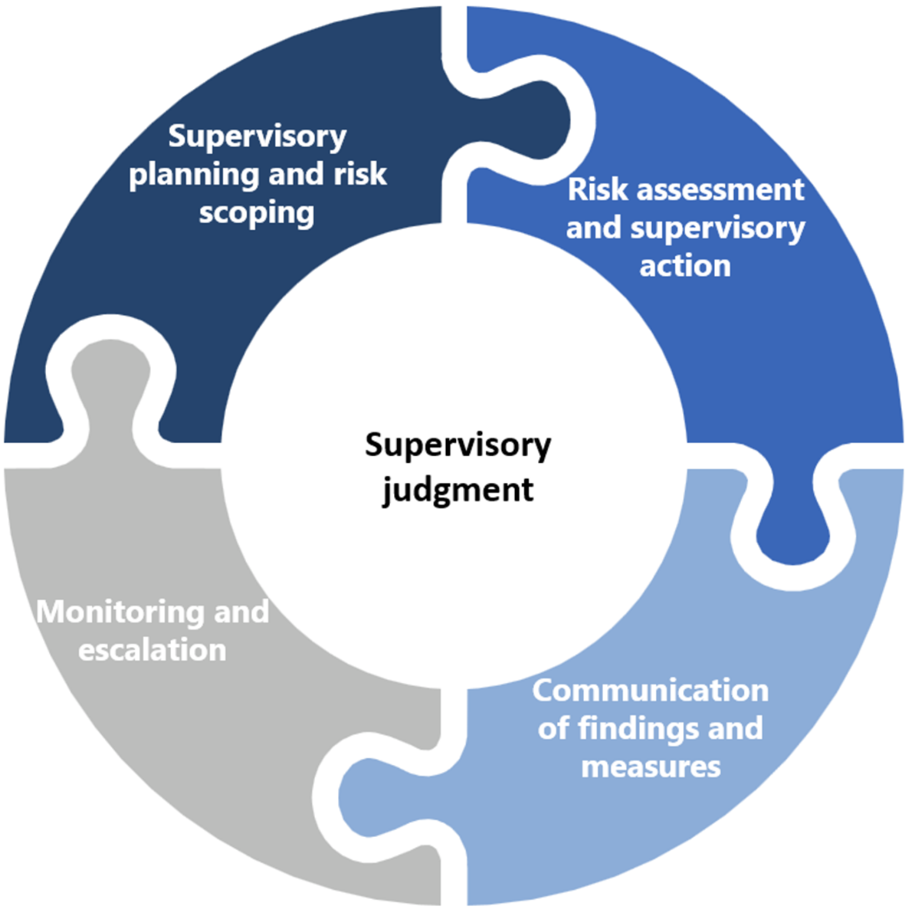
Section 3 – Overview of the supervisory process

Supervisory process

14. **Supervision relies on a structured and dynamic process that integrates multiple phases, ensuring risks are identified, assessed and addressed effectively.** While the specific methodologies and tools vary across jurisdictions, the supervisory life cycle typically encompasses four interconnected phases (Graph 2): supervisory planning and risk scoping, risk assessment and supervisory action, communication of findings and measures, and monitoring and escalation. Throughout each phase, supervisory judgment plays a crucial role, allowing supervisors to interpret complex information, adapt to evolving risks and make informed decisions tailored to the specific circumstances of each institution. Additionally, feedback loops that incorporate information from thematic and horizontal peer reviews are embedded within this process, enabling continuous learning and adaptation by integrating insights from previous measures and outcomes into future supervisory activities.

Typical components of the supervisory life cycle

Graph 2



15. **The supervisory planning and risk scoping phase is foundational to the entire supervisory process.** As supervisory resources are finite, effective risk scoping is essential for identifying potential weaknesses early, before they escalate into financial or operational distress. Conversely, inadequate or superficial risk scoping can lead supervisors to spread resources too thinly across multiple areas, reducing the likelihood of detecting critical issues and delaying the identification of key weaknesses. Effective risk scoping also allows supervisors to tailor planned supervisory activities to the size, complexity and risk profile of institutions, ensuring a targeted and efficient allocation of resources. In many ways, risk scoping operates under the principle of "seek and you shall find". Once supervisors define the areas of focus, the scoping decisions inherently shape the findings to be expected.

16. **The risk assessment phase enables supervisors to evaluate financial institutions' risk profiles, including the need for qualitative measures.** This phase is carried out through various supervisory engagements that are determined during the planning and risk scoping phase. These supervisory engagements may include a combination of off-site monitoring and analysis, on-site inspections, horizontal reviews, third-party reviews and stress testing. The frequency, depth and exact combination of the supervisory activities deployed at each institution depends on the bank's size and complexity; the nature of its specific risks, including the bank's existing or previously uncorrected weaknesses; and jurisdiction-specific approaches to supervision. Supervisors use these inputs, guided by supervisory methodologies tailored to their jurisdiction, to assess a bank's risk profile. Supervisors typically express a bank's overall risk profile through supervisory ratings assigned to each firm, which are often used as the basis for determining the need for supervisory actions, including qualitative measures.

17. **Supervisory measures turn risk assessments into actionable steps that address identified deficiencies.** These measures range from informal recommendations to formal enforcement actions, depending on the severity of the identified risks and the responsiveness of the institution. Their effectiveness lies in their ability to align the actions of supervised entities with supervisory expectations, promoting both corrective action and forward-looking risk mitigation. Supervisory measures vary in type, form and intensity and can be applied across all risk areas.

18. **Supervisory measures can be broadly categorised into quantitative and qualitative types, each serving distinct purposes in addressing risks.** Quantitative measures, such as capital and liquidity requirements, have a direct impact on financial metrics. These objective measures primarily address tangible financial risks, promoting comparability across institutions. In contrast, qualitative measures are more nuanced and rely far more on supervisory judgment, focusing on addressing the root causes of deficiencies, such as governance and risk management shortcomings or weaknesses in business models. While quantitative measures are designed to reinforce immediate financial resilience, qualitative measures seek to strengthen firms' soundness by enhancing internal processes such as risk management and control functions, decision-making, organisation and strategy. These measures are complementary, forming a cohesive framework for addressing both immediate and prospective risks.

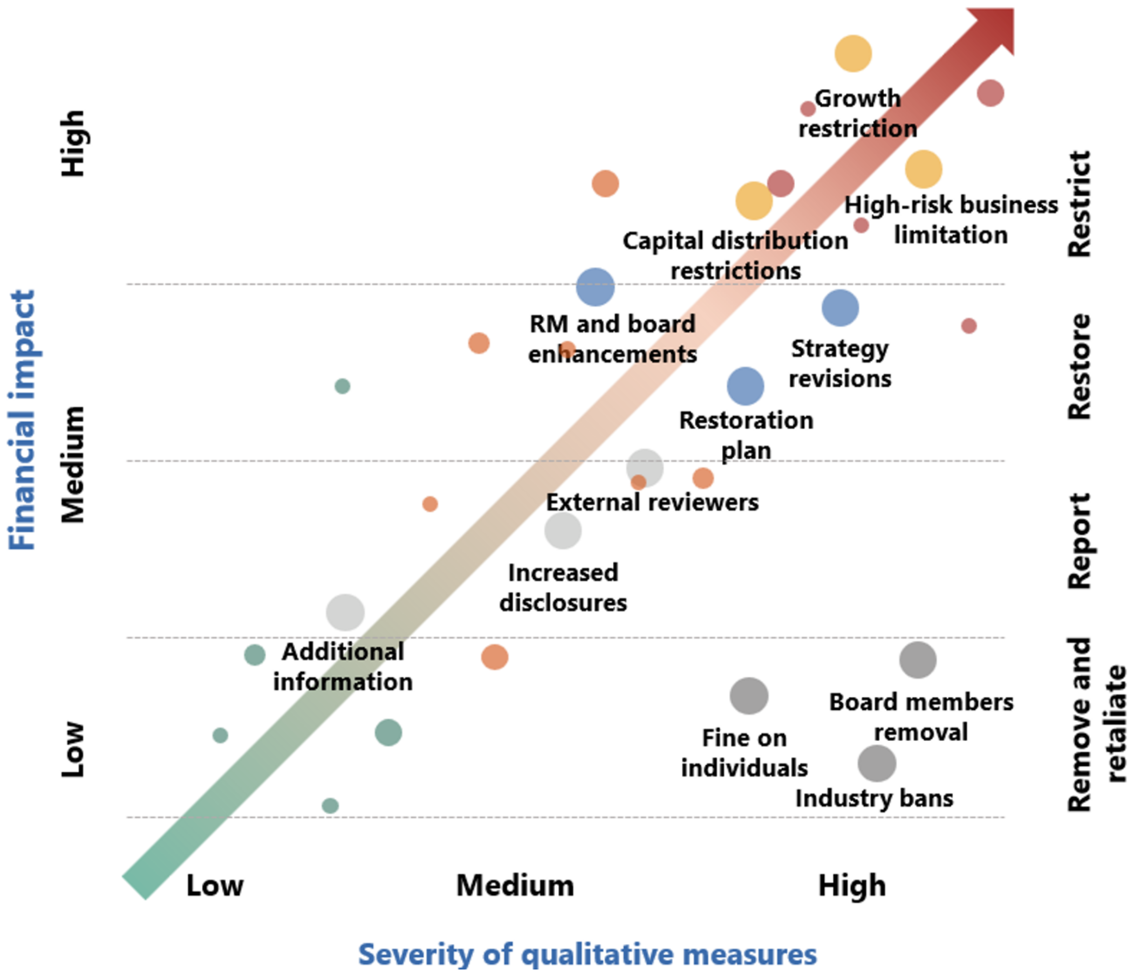
19. **Qualitative supervisory measures exist on a spectrum, with varying degrees of severity and financial impact.** Graph 3 illustrates this distinction; the y-axis (vertical plane) depicts the potential impact of various qualitative measures on a bank's financial metrics, while the x-axis (horizontal plane) categorises qualitative measures based on their severity, independent of their financial impact. A key takeaway is that qualitative measures do not operate in a binary manner, but exist along a continuum, where supervisory authorities can adjust their severity depending on the institution's risk profile and responsiveness.

20. **The financial impact of qualitative measures escalates in proportion to the severity of supervisory concerns.** The distribution of qualitative measures along the diagonal in Graph 3 suggests that the more severe a deficiency, the stronger the supervisory response, which in turn increases its financial impact. For instance, while enhanced reporting requirements may place an administrative burden on a bank, they have a relatively minor financial effect compared with business restrictions, which can significantly limit revenue generation. However, not all measures align neatly along this trend. A notable exception is qualitative measures directed at individuals, such as fines or the removal of senior

management or board members. These measures represent high-severity supervisory actions but have a relatively limited direct financial impact on the bank; instead, their consequences are primarily felt through governance changes and potential reputational effects. This exception highlights that while most qualitative measures follow an escalation pattern tied to financial impact, some interventions are targeted at structural improvements rather than immediate financial outcomes.

Illustration of qualitative measures by severity and financial impact[6]

Graph 3



21. **Communication of risk assessment results is a critical step in the supervisory process, serving as the formal bridge between the identification of weaknesses and the implementation of corrective measures.** Communication occurs both orally (eg through informal conversations and formal meetings with management and the board) and in writing (eg through dissemination of on-site inspection reports, letters and other written material). Written communication typically provides a detailed overview of the institution's risk profile, identifying specific areas of vulnerability and outlining the need for

[6] The qualitative measures in Graph 3 are illustrative examples that commonly arise in most situations. While qualitative measures can be tailored to specific circumstances, this graph offers a structured representation of the relationship between their severity (x-axis) and their typical financial impact (y-axis). It is, however, recognised that the specific requirements that accompany a particular qualitative measure may result in varying levels of financial impact. For example, if supervisors require a bank to enhance its reporting requirements and such requirements compel the bank to make significant investments in IT upgrades, including additional headcount to implement these system changes, such requirements can have a material financial impact.

corrective measures, if warranted. The manner in which these vulnerabilities are communicated has a significant impact on the bank's ability to comprehend – and thus address – the issues, the urgency of required actions and their alignment with supervisory expectations.

22. **Monitoring allows supervisors to assess the bank's progress in implementing corrective actions, including qualitative measures.** This phase involves ongoing supervision to track progress, assess compliance with supervisory expectations and identify whether additional measures are required. Monitoring mechanisms may include periodic reporting requirements, targeted follow-up assessments, enhanced engagement with senior management and data-driven off-site surveillance. Effective monitoring reinforces accountability for supervised entities and provides supervisors with critical insights into whether risks are being adequately mitigated or whether further escalation is needed. Failure to adequately monitor can result in a build-up of a previously identified risk or emergence of new risks.

23. **Escalation occurs when an institution fails to implement corrective actions or when new risks arise that necessitate a more stringent supervisory response.** Supervisory frameworks typically include structured escalation processes designed to increase pressure on institutions that do not address deficiencies within prescribed deadlines. Common escalation triggers include non-compliance with agreed timelines or corrective measures, recurring or long-standing issues, and the emergence of new and material risks. However, striking the right balance between maintaining constructive dialogue with the firm and ensuring timely and effective enforcement of supervisory expectations remains a key challenge.

24. **The closure of a supervisory measure marks the successful resolution of identified deficiencies to the satisfaction of the supervisory authority.** Once the institution has fully implemented the required corrective actions and demonstrated their effectiveness, the measure is formally closed. Closure decisions are typically based on a combination of evidence, including supervisory reviews, follow-up assessments and, in some cases, third-party validation (eg external audits or independent evaluations). However, closure does not signify the end of supervisory attention. In many cases, the resolved measure enters a feedback loop within the supervisory framework, serving as a reference point for future assessments and ongoing monitoring. This feedback mechanism ensures that lessons learned from the measure are integrated into the supervisory approach, helping to refine risk scoping, enhance supervisory methodologies and identify emerging patterns or recurring weaknesses.

25. **Supervisory judgment is a critical component at every stage of the supervisory process, ensuring flexibility and adaptability to the unique circumstances of each institution and situation.** In the scoping phase, judgment plays a vital role in identifying priority areas for scrutiny, helping supervisors allocate resources effectively based on risk. During the risk assessment phase, judgment is essential in interpreting both quantitative and qualitative inputs to develop a comprehensive understanding of the institution's risk profile. This ensures that assessments go beyond purely numerical metrics to capture nuanced and emerging risks. In the implementation of supervisory actions, judgment guides the selection of appropriate measures to address identified deficiencies, ensuring they are proportional to the severity of the risks. Similarly, in communication, judgment is required to effectively convey the urgency, clarity and expectations of supervisory findings to institutions. During escalation, supervisory judgment is indispensable in determining the appropriate timing and intensity of additional measures when deficiencies are not resolved or when new risks emerge.

26. **However, the application of supervisory judgment requires acceptance of potential risks.** Supervisory authorities must be prepared to tolerate some degree of failure or unintended consequences when judgment-driven decisions prove incorrect. Willingness to accept this level of risk requires supervisory authorities to define and embrace their own risk appetite when exercising judgment.

Section 4 – Supervisory planning and risk assessment

27. **In all jurisdictions, the supervisory framework guides both the oversight of individual firms and the need for qualitative measures.** BCP 8 outlines the key elements needed for an effective supervisory approach (BCBS (2024)). This principle requires, among other items, that supervisors: (i) develop and maintain a forward-looking assessment of the risk profile of individual banks, proportional to their systemic importance; (ii) identify, assess and address risks emanating from banks and the banking system as a whole; and (iii) have a framework in place for early intervention. This section covers how authorities plan supervisory activities and assess banks' risk profiles, with a particular focus on governance and business model assessments.

Supervisory planning and risk scoping

28. **Risk scoping and supervisory planning are the processes through which priorities and focus areas are defined, directing the allocation of supervisory resources to firms and activities that pose the greatest risks to the banking system.** As such, the methods supervisory authorities deploy to determine key areas of focus and the specific activities to be completed during the supervisory cycle set the broader context for the risk assessment process. If high-risk areas within individual banks are not properly identified during the risk scoping phase, supervisors may misdirect resources, potentially overlooking critical vulnerabilities. Therefore, the quality of risk scoping has a direct impact on the depth and focus of supervisory assessments, shaping the scope and severity of supervisory findings.

29. **Most supervisory authorities in our sample combine top-down and bottom-up approaches in formulating the supervisory plan for a given bank.** The top-down approach, while not specific to any individual institution, serves as the starting point for the development of supervisory plans. It reflects the supervisory authority's collective views on key supervisory priority areas for the banking sector in their respective jurisdictions for the upcoming supervisory cycle.[7] In contrast, the bottom-up assessment considers a bank's systemic importance and complexity together with an evaluation of its bank-specific risks. A bank's systemic importance is typically determined by regulatory-driven indicators such as size, interconnectedness and substitutability, while bank-specific risks are determined by supervisory teams overseeing individual banks. These elements – which integrate top-down and bottom-up approaches – are considered in determining the planned supervisory activities for a particular bank. They are inherently complementary: the top-down approach offers a bird's eye view, considering elements of peer comparison in establishing strategic priorities and systemic alignment across the sector, while the bottom-up approach works from within, focusing on institution-specific risks and vulnerabilities.

30. **Both approaches share a key similarity: they are not static and may be adjusted during the supervisory cycle in response to emerging risks and shifting priorities.** However, top-down approaches tend to be less flexible, as new risks typically must be significant enough to warrant a sector-wide adjustment in supervisory priorities. In contrast, bottom-up approaches are inherently more responsive, allowing supervisors to adapt quickly to institution-specific risks as they arise. This dynamic interplay between the two approaches ensures that supervision remains both strategically aligned and operationally adaptable to changing risk landscapes.

31. **Top-down approaches vary in terms of time horizon and the degree of transparency in the supervisory planning process.** While most jurisdictions develop top-down priorities for the coming 12 months, others provide a multi-year strategic direction for their banking sector.[8] The level of

[7] These views are shaped by information that may be drawn from various sources, including common areas of concern resulting from previous supervisory reviews; trends in the macro-financial, regulatory and operating environment; geopolitical developments and views from relevant market participants.

[8] The ECB establishes supervisory priorities over a rolling three-year time horizon.

transparency in key supervisory priorities also varies across jurisdictions; while five of eight sampled jurisdictions publish their supervisory priorities, the level of detail differs significantly.[9]

32. **Among jurisdictions that publish top-down supervisory priorities, approaches differ in terms of both the format and level of direct engagement with regulated entities.** While most jurisdictions publish their supervisory priorities on their website, others adopt more direct and targeted approaches. For example, the United Kingdom's (UK) Prudential Regulation Authority (PRA) also sends its priorities directly to the CEOs of regulated entities through a Dear CEO letter. This letter outlines thematic supervisory priorities, clarifies that they are not exhaustive and emphasises that they complement core supervisory work and firm-specific feedback from Periodic Summary Meetings (PSM). By addressing the letter to the CEO and encouraging discussion with the board, the PRA ensures that supervisory expectations are embedded at the highest levels of decision-making, enhancing institutional accountability. Additionally, the letter is signed by high-level supervisors, such as executive directors, which reinforces the importance and authority of the communication.

33. **Bottom-up approaches differ in terms of how systemically important firms are considered in supervisory plans.** All jurisdictions require more frequent on-site reviews (or continuous supervision) for larger firms than for smaller banks, and most defer to the judgment of supervisory teams to determine areas of supervisory focus. In addition, some jurisdictions' (Australia and Canada) risk rating systems require more granular risk assessments of specific areas as an institution's systemic footprint increases, ensuring a more in-depth evaluation of key risks[10].

34. **Firm-specific supervisory plans are not published, which points to the confidential and tailored nature of bottom-up approaches**. These plans are communicated directly to institutions, often through targeted discussions or formal meetings. This approach allows supervisors to address individual banks' unique risk profiles and vulnerabilities in a customised and confidential manner.

Supervisory risk assessment

Overview

35. **While the overarching goal of measuring the default risk of supervised entities is consistent across jurisdictions, there are notable differences in the design of supervisory methodologies.** As evidenced by our sample of eight jurisdictions, risk assessment methodologies often cover different risk areas or assign varying levels of importance to specific risk categories. The scoring designs employed by supervisory authorities also show considerable variation. Most jurisdictions use numerical scales, while others, such as the FRB's large financial institutions (LFI) rating system in the United States (US), rely on qualitative descriptors (FRB (2019)). Although a few jurisdictions provide detailed definitions of their ratings, in many cases they remain broad and lack sufficient specificity, creating potential challenges in ensuring consistency and comparability. Furthermore, some authorities, such as those in the US, provide comprehensive public resources like examination manuals, which enhance clarity and consistency in supervisory expectations, while others do not disclose any aspects of their methodologies.

36. **These differences in risk assessment methodology can influence the application of qualitative supervisory measures.** The level of granularity in risk assessments affects how early supervisors can detect weaknesses in governance, business models or risk management, key areas where qualitative measures are typically applied. In jurisdictions with more detailed rating methodologies, qualitative measures can be deployed in a more structured manner, whereas in systems with broader or less defined criteria, the application of qualitative measures may depend more heavily on supervisory

[9] These jurisdictions include Australia, Canada, the EU (ECB), the UK and the US (OCC).

[10] Such an approach requires supervisors to carry out sufficient work to arrive at relevant risk assessments, thus limiting, to some extent, supervisory discretion in the bottom-up risk scoping process. See APRA (2020) and OSFI (2024a) for further details.

judgment. Furthermore, where rating systems emphasise qualitative factors, such as governance or risk management, banks may face earlier supervisory interventions in the form of strategic adjustments or leadership changes rather than purely financial measures.

Rating system architecture

37. **A core element of all supervisory frameworks is the rating system used to assess the health of banks; and the results of this assessment often drive the need for supervisory actions, including qualitative measures.** Supervisory rating systems for banks (hereafter referred to as "risk rating systems") form the backbone of the supervisory review process under Pillar 2 of the Basel Framework. They are used as the basis for determining the risk profile of individual banks (Principle 2 of Pillar 2) and for intervening in banks at an early stage to address identified concerns in their financial condition or risk management (Principle 4 of Pillar 2). While the BCPs are not prescriptive on how supervisory risk rating systems should be designed or what areas they should cover, they emphasise the importance of methodologies that include, among other things: (i) an assessment of risks related to a bank's business models, including business model sustainability; and (ii) a forward-looking view of a bank's risk profile.

38. **Risk rating systems in sampled jurisdictions share common features**. These shared characteristics encompass three main areas, covering both quantitative and qualitative elements (Table 1). First, in all cases there is a requirement to explicitly rate a firm's overall governance or management. Second, all surveyed jurisdictions rate capital and liquidity on a standalone basis,[11] though some (eg Brazil) also utilise these ratings as part of a broader assessment of business models.[12] Third, surveyed jurisdictions' rating systems encompass an assessment of a firm's material risks, covering both inherent risk and the underlying risk control systems. As these risks may encompass both financial (eg credit risk, market risk, interest rate risk etc) and non-financial (eg operational risk etc) dimensions and require supervisors to assess how well such risks are being managed, the "assessment of material risks" component comprises both qualitative and quantitative elements.

39. **Despite sharing common characteristics, risk rating systems for banks retain distinct nuances specific to each framework**. While all interviewed jurisdictions assign an overall rating, the structure and scale of these ratings range from four to eight levels. Canada employs an eight-level scale, which is not evenly distributed – the first four levels represent minimal to moderate risk, while the remaining four levels encompass higher-risk categories, allowing for greater differentiation across the entire risk spectrum (OSFI (2024b)). While Brazil employs a rating scale from 1 to 4, institutions that are rated from 2 to 4 are assigned qualifiers ("+" or "–"), while 1-rated firms also have a "–" qualifier. Within the ECB, each component of the supervisory review process is rated on a scale from 1 to 4, but scores of 2 and 3 can be assigned qualifiers ("+" or "–"), providing a more refined risk assessment (ECB (2024a)).

40. **The number and distribution of rating levels can influence the application and effectiveness of qualitative measures by shaping how supervisors differentiate risk levels, determine supervisory intensity and trigger corrective actions.** A more granular rating system – such as Canada's eight-level scale – allows supervisors to capture nuanced differences in risk profiles, which can facilitate more proportional and targeted supervisory activities and interventions when warranted.[13] In Canada's case, banks ranking among the four levels assigned to low- to moderate-risk institutions may still be subject to qualitative measures as precautionary steps before financial deterioration occurs. On the

[11] Australia and Canada rate capital and liquidity separately for larger institutions but provide a combined "financial resilience" rating for smaller firms.

[12] Brazil rates capital and liquidity on a standalone basis, but uses these ratings as components of the business model assessment. See BCB (2025) for further details.

[13] In addition to risk ratings, Canada also 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.

other hand, a more granular rating system requires greater supervisory judgment, potentially leading to greater challenge from firms on their assigned risk ratings.

Main features of bank rating systems – key elements explicitly rated

Table 1

	Quantitative		Qualitative				Overall rating
	Financial resilience	Assessment of all material risks		Governance	Viability of business models	Resolvability	
Australia[14]	✓	✓	✓	✓	✓		Six levels
Brazil	✓	✓	✓	✓	✓		Four levels (with qualifiers)
Canada	✓	✓	✓	✓	✓		Eight levels
China	✓	✓	✓	✓			Six levels
EU	✓	✓	✓	✓	✓		Four levels (with qualifiers)
Singapore[15]	✓	✓	✓	✓			Four levels
UK	✓	✓	✓	✓	✓	✓	Five levels
US (OCC)	✓	✓	✓	✓			Five levels

41. **A key difference is how business model assessments are incorporated into supervisory risk ratings.** Slightly more than half of sampled jurisdictions require supervisors to provide an explicit assessment of banks' business models (Table 1). Jurisdictions that do not explicitly rate business models may still indirectly consider this element as part of a broader assessment of a firm's risk profile. These differences can influence not only the outcomes of risk assessments, but also the type and intensity of qualitative measure needed to address identified business model deficiencies.

42. **Among jurisdictions that prescribe an explicit rating for business models, there is no consensus on how it should be reflected in supervisory rating systems nor on what factors should drive the assessment.** At one end of the spectrum is Brazil, which assigns a stand-alone business model rating based on an evaluation of several factors, including a bank's strategy, capital adequacy and liquidity position, and profitability.[16] At the other end, Australia, the EU (ECB) and the UK assess business models independently of assessments related to capital and liquidity (Bank of England (2023)).

43. **In theory, the decision on whether business models are explicitly rated or implicitly considered in risk rating systems can directly influence the scope and application of qualitative supervisory measures.** When business models are assessed as an explicit component of the risk rating system, deficiencies are directly linked to the overall rating, making weaknesses immediately visible and potentially triggering proportional supervisory measures.[17] When business model risks are implicitly considered in risk rating systems, their influence on the overall rating is less traceable. Because business model considerations are interwoven with other rating components, their deficiencies can be diluted or

[14] Australia assesses "resolvability" separately from its risk rating system.

[15] See MAS (2024) for details.

[16] Canada's business risk assessment evaluates several factors, including a bank's strategy and profitability. The assigned business risk rating also reflects additional impacts to business risk relating to other categories, such as capital and liquidity.

[17] For example, if a bank's business model is assessed to be unsustainable, this will automatically lower its risk rating and increase supervisory scrutiny, leading to possible capital add-ons, enhanced risk governance expectations or activity restrictions.

compensated by strengths in other areas, such as capital or asset quality. This may introduce layers of "noise" that obscure visibility on business model risks, especially when a bank exhibits strong financial metrics but operates an unsustainable or excessively risky business model.

44. **Another critical difference lies in the adoption of the "weakest link" approach, which fundamentally shapes how overall ratings are determined.** Australia and Canada have adopted such an approach in their supervisory rating systems, whereby a poor rating in any single component (eg governance) drives the overall rating assigned to a firm (APRA (2020), OSFI (2024a)). However, a poor rating in a single component is typically based on the supervisory view on the significance of the identified area(s) of concern and its (their) potential impact on a firm's viability or critical operations. This approach ensures that qualitative weaknesses in one area are not diluted or obscured by a strong score in another element, such as capital or liquidity.

45. **Some jurisdictions place greater weight on the governance assessment in relation to other components within their supervisory rating system.** China's rating system, which includes an assessment of nine individual components, attaches an explicit 20% weight to the corporate governance and management quality rating, which is higher than the weights attached to any other individual component in its rating system.[18] This explicit weighting highlights the critical role of governance/management in shaping a firm's overall risk profile. The governance rating heavily influences the composite rating assigned to a firm, which in turn determines the supervisory stance and the need for qualitative measures.

46. **Both the weakest link approach and non-uniform weighting of qualitative components in supervisory rating systems offer distinct advantages in addressing deficiencies, though they operate in different ways.** The weakest link approach can be effective at ensuring that critical weaknesses in any single area cannot be overlooked, making it well suited for cases where severe vulnerabilities require immediate supervisory intervention. By contrast, non-uniform weighting systems, such as those that assign greater emphasis to governance, help prioritise supervisory focus on areas that have a broader impact on an institution's overall risk profile. While the weakest link approach prevents individual deficiencies from being masked by stronger ratings in other areas, weighted systems provide a structured and proportional assessment that reflects the relative importance of different risk components in shaping a firm's resilience. It is also important to note that the weakest link approach is not exclusive to governance assessments, but it applies to any key risk area where serious deficiencies arise.

47. **The US Board of Governors of the Federal Reserve System's (FRB) LFI rating system places, arguably, the most emphasis on qualitative elements within its rating system**. Although it was developed for large bank holding companies, the qualitative features embedded in the LFI rating system may still have relevance in the broader design of bank rating systems. The LFI rating system contains three components covering: (i) capital planning and positions; (ii) liquidity risk management and positions; and (iii) governance and controls (FRB (2019)). The capital and liquidity ratings include quantitative components and qualitative risk management standards as they relate to capital planning and liquidity risk management, respectively. The governance and controls component covers non-financial risks as well as risk management and controls generally. The rating is informed by the quality of board oversight, effectiveness of independent risk management units and internal audit, as well as the firm's management of risks such as cyber security and compliance, among other risk and control matters. While no composite rating is assigned, the weakest component rating dictates the overall supervisory stance, ensuring that any significant shortcoming in governance or risk management sets the context for supervisory actions (see Box 1 for details).

[18] China also rates the following eight additional elements, with the corresponding weights attached to each element noted in parentheses: capital (15%), asset quality (15%), profitability (5%), liquidity risk (15%), market risk (10%), data governance (5%), IT risk (10%) and institutional differentiator (5%). See NFRA (2021) for further details.

Box 1

The FRB's LFI rating system

The FRB introduced its large financial institution (LFI) rating system in 2019 and is applicable to all bank holding companies with total assets of $100 billion or more① The LFI rating system is designed to: (i) enhance the clarity and consistency of supervisory assessments; and (ii) provide transparency on the consequences of a given rating. Key features of the LFI rating system, including the implications of an assigned rating, are described below.

LFI rating components: The LFI rating system consists of three components:

i. *Capital planning and positions* covers both qualitative and quantitative elements that encompass: (a) the effectiveness of a firm's governance and the planning processes used to determine its capital position; and (b) the adequacy of capital held to meet regulatory requirements and to support its intermediary activities through a range of conditions.

ii. *Liquidity risk management and positions* covers both qualitative and quantitative elements that encompass: (a) the effectiveness of a firm's governance and the risk management processes used to determine its liquidity needs; and (b) the adequacy of a firm's liquidity positions to meet regulatory requirements and to support its ongoing obligations through a range of conditions.

iii. *Governance and controls* covers qualitative elements and considers the effectiveness of a firm's: (i) board; (ii) management of business lines and independent risk management and controls; and (iii) recovery planning.② This component assesses a firm's effectiveness in aligning strategic business objectives with its risk appetite and overall risk management and control functions.

LFI rating scale: Each LFI component is assigned a rating based on a four-level scale: (i) broadly meets expectations; (ii) conditionally meets expectations; (iii) deficient-1; and (iv) deficient-2. There is no composite rating assigned, and a firm must be rated "broadly meets expectations" or "conditionally meets expectations" for each of the three components to be considered "well managed" in accordance with various regulations (firms that are not well managed are subject to certain restrictions).

Two-way links between ratings and actions: The FRB outlines the consequences for each assigned rating and links rating upgrades to a firm's ability to resolve and address identified supervisory concerns. Similarly, an inability to address supervisory concerns in a timely manner could result in a downgrade.

i. *Rating consequences for "broadly meets expectations"*: The firm may be subject to identified supervisory issues that require corrective actions, but the identified issues are unlikely to present a threat to its safety and soundness.

ii. *Rating consequences for "conditionally meets expectations"*: The FRB has noted that it does not intend for firms to be assigned a "conditionally meets expectations" rating for a prolonged period and will work with the firm to develop a timetable to resolve the identified issues in order to support an upgrade to the "broadly meets expectations" rating. Failure to address deficiencies would most likely result in a downgrade to a "deficient-1" rating.

iii. *Rating consequences for "deficient-1"*: A firm that falls in this rating category is required to take timely corrective action to remedy financial or operational deficiencies and to restore and maintain its safety and soundness. There is also a strong presumption that a firm with this rating will be subject to informal or formal actions and its ability to engage in new or expansionary activities that require FRB approval may be hindered.

iv. *Rating consequences for "deficient-2"*: Firms in this category are required to immediately implement corrective measures and demonstrate adequacy of contingency planning. There is a strong presumption that this rating category will trigger a formal action, and the FRB is unlikely to approve any request from the firm to engage in new or expansionary activities.

① The LFI rating system is also applicable to US intermediate holding companies of foreign banking organisations with combined US assets of $50 billion or more. ② The recovery planning requirement applies only to the eight largest domestic firms that are subject to the FRB's Large Institution Supervision Coordinating Committee framework.

48. **Final risk assessment decisions rely on expert judgment and structured committee reviews to ensure consistency and accountability.** All sampled jurisdictions include quality assurance processes to support and validate risk rating decisions. In the UK, the PRA dedicates a half-day discussion to assessing the risks for each major bank, with peer comparisons considered selectively to inform the analysis. Senior PRA executives – including directors of supervision and risk – review findings, which are then validated by the Prudential Regulation Committee, chaired by the Governor. In Canada, group rating committees, comprising senior supervision leaders, meet regularly to finalise ratings for large institutions before the ratings are shared with the institutions' senior management and boards.

Governance and business model assessments

49. **Supervisory assessments of governance and business models serve as leading indicators of a firm's future risk profile, making them critical in identifying and addressing the root causes of problems in banks at an early stage.** Decisions taken by a bank's board and senior management, including the effectiveness of their risk oversight and strategic direction, have significant implications for a firm's prospective risk profile. These decisions eventually manifest in banks' key financial metrics, either reinforcing overall strength or amplifying vulnerabilities. Similarly, unsustainable business models may only become evident over time. To address these risks, supervisors focus efforts on detecting early signs of weaknesses in bank governance and business models. However, assessing governance and business models presents challenges as these evaluations are often subjective, difficult to measure and reliant on supervisory judgment. Some firms may appear formally compliant while lacking effective oversight, and business model vulnerabilities may only become apparent once financial performance declines.

50. **In all sampled jurisdictions, there is an expectation that governance and risk management controls at large banks should be greater than those for less complex or smaller banks, though very few authorities make this differentiation explicit in applicable regulation.** Consistent with the principle of proportionality, all authorities expect more robust governance and risk standards at larger banks vis-à-vis smaller institutions in order to address their greater systemic importance and operational complexity. However, what constitutes "more robust governance and risk management" at larger firms is often not strictly defined and typically left to supervisory judgment. The US Office of the Comptroller of the Currency (OCC) has developed guidelines that require banks with consolidated total assets of $50 billion or more to meet heightened risk management expectations that are codified in regulation in order to support supervisory risk assessments of governance and to help applicable banks align with supervisory expectations (OCC (2014)). Among other items, the guidelines provide minimum standards for institutions' boards of directors in overseeing the risk governance framework.

51. **Some authorities have published "red flags" and related supervisory guidance to facilitate the early identification of weaknesses in governance and risk management.** These frameworks aim to clarify expectations, enhance transparency and promote sound corporate governance practices across the banking sector. In the US, the OCC has published various qualitative indicators covering board, senior management and risk management weaknesses (OCC (2021)). These indicators support supervisory assessments by helping examiners and industry alike to better understand what constitutes poor governance practices.[19] In the EU, the ECB published a draft guide outlining its expectations when assessing the governance and risk culture of supervised entities (ECB (2024b)). However, this approach shifts the focus from identifying deficiencies to actively promoting best practices, ensuring that firms have a clear benchmark for aligning with supervisory expectations. Despite this difference in approaches, both

[19] These include but are not limited to: (i) failure to implement timely and effective corrective action proposed by supervisors; (ii) dominant influence from individual owners, senior managers or directors without appropriate safeguards; (iii) a passive or uninformed board of directors who do not sufficiently challenge management; (iv) inadequate expertise and experience of senior management; (v) increasing or ongoing non-compliance with regulatory requirements and internal bank policies; (vi) insufficient planning and audit weaknesses; and (vii) risk management systems that do not keep pace with growth or complexity.

methods share common aims of fostering sound governance in banks while providing tangible guidance to supervisory teams to support the early identification and remediation of weak governance practices.

52. **Other authorities have introduced individual accountability regimes (IARs) to strengthen supervisors' ability to hold firms' key decision-makers accountable for failures in their areas of responsibility.** Initially adopted in the UK, followed by Australia and Singapore, a key feature of all IARs is the requirement for firms to clearly define, formalise and document responsibilities allocated to senior officials. This structured allocation of responsibilities ensures that key decision-makers cannot evade accountability by diffusing responsibility across management layers. Each IAR therefore aims to hold senior officials accountable for those that work beneath them, unless they have taken "reasonable" or "adequate" steps to prevent material breaches or failings from occurring or continuing once detected. In theory, this means that if banking supervisors identify shortcomings in corporate governance, they can review firms' allocation of responsibilities to identify the person(s) responsible and take remedial actions, if warranted, at an early stage (Oliveira et al (2023)).

53. **Business model assessments have become an area of supervisory scrutiny, and authorities continue to refine their frameworks with high-level indicators to evaluate the sustainability of banks' business models.** In the EU, the ECB's business model assessment framework focuses on four key dimensions: (i) a bank's ability to generate stable returns over the short, medium and longer terms; (ii) its strategic positioning in the market; (iii) its ability to carry out its business and generate returns in an effective way; and (iv) its resilience to external shocks, including the ability to manage key dependencies and adapt to structural shifts and new developments (ECB (2024b)). Similarly, Canada considers an institution's ability to achieve targets and generate capital in alignment with its risk appetite, taking into account the level of vulnerability to external factors. Business risk is one of the drivers of the overall risk rating, and vulnerabilities could trigger supervisory actions, depending on firm-specific circumstances. Australia and the UK have also developed indicators to support business model assessments.[20]

54. **By nature, business risk assessments are subject to a multitude of unknowns, posing significant challenges for supervisors.** These include external factors such as macroeconomic shifts, technological disruptions and regulatory changes, which can have a negative impact on the viability of a business model over time. Thus, there is a need for highly skilled examiners who can identify weaknesses early, exercise sound judgment and escalate issues when necessary. Otherwise, there is a risk that hidden business model vulnerabilities only surface after financial deterioration has already begun. Despite the progress made to date, several interviewed jurisdictions consider that further refinements to supervisory guidance may help to support supervisory assessments of business model sustainability.

Section 5 – Supervisory actions

55. **The outcome of a risk assessment serves as the foundation for determining the intensity and type of supervisory action required to address identified deficiencies.** Supervisory frameworks typically integrate a risk-based approach, ensuring that actions are proportional to the level of risk identified. Low- to moderate-risk findings may result in recommendations or enhanced oversight, allowing institutions to self-correct through improved governance or risk management practices. In contrast, high-risk deficiencies, such as those affecting financial resilience, governance or business model sustainability, often trigger more intrusive interventions, including legally binding corrective measures. This ensures that supervision remains preventive rather than reactive, addressing weaknesses before they escalate into crises.

[20] See Coelho et al (2022) for further discussion on supervisory practices for assessing bank business models.

56. **This section covers various issues related to jurisdictional approaches to supervisory actions.** It includes: (i) the range of supervisory instruments available, as well as those that are typically used to take informal or formal actions; (ii) the linkages between composite risk ratings and supervisory actions, including the circumstances under which moral suasion, informal and formal actions are used; and (iii) the nature, type and effectiveness of the qualitative measures taken in response to weak governance and business model assessments.

Supervisory instruments

57. **Supervisory instruments refer to the mechanisms authorities use to convey areas of supervisory concern, including the need for corrective actions.** These instruments range from informal oral communications (eg moral suasion) with bank boards and senior management to various forms of written communication, depending on the nature and severity of the identified concerns. They serve as the bridge between the assessment of risks and the steps required to address them, ensuring that identified issues are effectively communicated and acted upon.

58. **Supervisory authorities use a combination of formal and informal instruments to address deficiencies in banks.** Informal supervisory instruments are non-binding and discretionary, designed for early-stage intervention before financial deterioration occurs. While the nature and type of informal instrument varies across surveyed jurisdictions, a common aim of all informal actions is reliance on voluntary corrective actions, fostering cooperative compliance rather than enforcement. These informal instruments are typically confidential, flexible and proportional, allowing supervisors to signal concerns without imposing legal obligations. In contrast, formal supervisory instruments are legally binding measures imposed when deficiencies are persistent or material or pose significant risks to a bank's stability. These include capital directives, enforcement orders, business restrictions and monetary penalties, which mandate corrective actions and may require public disclosure or board-level intervention. Unlike informal measures, formal instruments carry legal consequences. Table 2 illustrates the range of informal and formal supervisory instruments available in sampled jurisdictions.

59. **The choice between informal and formal tools depends on multiple factors, including the severity of the deficiency, the institution's history of responsiveness and the effectiveness of prior supervisory engagement.** When banks demonstrate a willingness and capability to self-correct, informal tools are often sufficient to drive remediation. However, when issues remain unresolved or recur frequently, formal measures become necessary to enforce compliance and ensure a clear supervisory response. All interviewed jurisdictions agreed that effective supervision requires a balanced approach, where most issues are addressed through informal engagement, while formal actions are reserved for cases where informal measures have not led to sufficient progress or where severe risks emerge suddenly and require immediate intervention.

Illustration of the spectrum of supervisory tools available across surveyed jurisdictions

Table 2

	US (OCC)	ECB (SSM)	Canada	UK	Singapore	Australia	Brazil	China
Informal instruments	Moral suasion Commitments Matters requiring (board) attention (MRAs/MRBAs) Board resolution Memorandum of understanding (MoU)	Moral suasion Operational act	Moral suasion Supervisory letter	Moral suasion Supervisory letter "Dear CEO" letter Periodic Summary Meetings (PSM) letter	Moral suasion Written recommendations Inspection/Supervisory Letters Supervisory warning (reprimand)	Moral suasion Suggestion Recommendation Requirements Supervisory letters (incl. reprimand)	Moral suasion Inspection letter	Moral suasion Recommendations Risk warning letters Regulatory opinions
Formal instruments	Written agreements (Temporary) cease and desist (C&D) orders Prompt Corrective Action (PCA) Directives Prohibition and Removal Authority Civil Money Penalties License withdrawals	ECB decision Ancillary provisions Periodic penalty payments Sanctions License withdrawals	Prudential agreement Undertakings Business restrictions Directions and Orders External Auditor Report Request External Specialist Opinion Enhanced Business Restrictions Cease and Desist Orders Monetary Penalties Court Orders Criminal Penalties License withdrawals	Skilled Persons Report Early Account Scheme & Enhanced Settlement Discount Statutory notices Penalties Public Censure Prohibitions License limitations or withdrawals	Escalation letter Independent audit/review Directions Fines Business restrictions Civil/criminal penalty proceedings License withdrawals	Special purpose engagement Notices to produce Formal Investigations Witness Examinations Directions Formal directions Court injunctions Enforceable Undertakings Infringement Notices Criminal penalties Licence Conditions	Prudential preventive measures Term of Attendance Term of Commitment Precautionary Measures Bound Deposit Sanctioning Administrative Process Fines and Sanctions Coercive measures Licence withdrawals	Public reprimands Mandatory corrections Fines Coercive measures Civil/criminal penalty proceedings Licence withdrawals

60. **Supervisors prefer informal instruments as these allow them to address risks effectively while minimising disruption.** Within the range of informal instruments, supervisors often employ moral suasion. Moral suasion – the first tool at a supervisor's disposal when identifying a deficiency – relies on persuasion and influence. It is not backed by any of the other informal tools listed in Table 2, and it serves as an initial means of encouraging voluntary compliance and corrective action. As such, moral suasion can be considered the most informal of the range of informal tools available to supervisors. Beyond moral suasion, other informal instruments address concerns while still maintaining a collaborative relationship with institutions, avoiding the need for resource-intensive formal actions. A key difference between moral suasion and other informal tools is that the latter are typically communicated in writing through official supervisory channels and documents between the bank and the supervisory authority, while the former is conveyed mainly in oral form and not tied to specific consequences for failure to take correction action. Escalation to formal measures is typically reserved for situations in which risks remain unresolved or worsen.

61. **The transition from informal to formal supervisory instruments is rarely clear-cut, as it depends on a range of contextual factors rather than predefined triggers.** No jurisdiction follows standardised criteria for making this shift, leaving much of the decision to the discretion of supervisors. Several key factors influence this process, including, among others: (i) the bank's supervisory rating and overall financial condition; (ii) the number and severity of unresolved supervisory concerns; and (iii) the bank's track record in implementing corrective actions. Nonetheless, the supervisory authority in Canada maintains a publicly available menu of actions which outlines the specific measures it may apply based on an institution's staging (rating) or proximity to failure. The supervisory authority in the UK provides a qualitative overview of some of the actions it can deploy by documenting its supervisory approach publicly.

62. **The existence of formal instruments serves a dual purpose: they can be deployed when necessary and can also act as a deterrent, motivating banks to comply early.** Banks often voluntarily comply with supervisory measures for several reasons, such as respect for the supervisor's authority, trust in its expertise or recognition that formal enforcement actions would be more punitive and costly. This dynamic highlights the effectiveness of supervisory oversight; the mere availability of enforceable authority fosters an environment of compliance without the need to frequently resort to formal instruments. Supervisory authorities in Australia and the UK have introduced frameworks to foster greater individual accountability of firms' senior executives and boards, which have been effective in prompting early action. This approach enhances the focus and accountability of individuals in key roles, reinforcing their responsibility for and commitment to addressing supervisory concerns proactively.

63. **Some authorities use a variety of supervisory instruments to differentiate degrees of supervisory concern, while others prefer simpler approaches**. In some jurisdictions, such as Canada, the EU (ECB) and the UK, supervisory letters are the primary vehicle for communicating findings and implementing supervisory actions. For example, in the ECB,[21] supervisors rely on operational acts and outcomes of supervisory rating decisions, both of which are essentially letters, to formalise supervisory expectations and enforce corrective measures where necessary. In contrast, other jurisdictions, such as the US, adopt a broader approach, creating a diverse set of instruments – both formal and informal – with varying levels of severity to address different supervisory needs. Some jurisdictions (eg Australia) follow a hybrid model, maintaining a wide array of instruments in theory but predominantly relying on a selected few in practice. Despite these differences, most jurisdictions find that their existing toolkit adequately supports their supervisory responsibilities.

64. **Jurisdictions that rely heavily on one instrument to seek corrective actions have developed mechanisms to convey the urgency and severity of supervisory findings.** For instance, in Canada, the Office of the Superintendent of Financial Institutions (OSFI) issues an annual supervisory letter to banks,

[21] Operational acts are legally non-binding and serve to communicate supervisory expectations and recommendations, while SREP decisions are legally binding and enforce corrective measures where necessary.

summarising the results of the yearly assessment and outlining key findings and action items. OSFI also issues interim supervisory letters throughout the year, with larger institutions receiving more frequent updates; these interim letters provide more detailed information on findings and action items, enabling institutions to address supervisory concerns more promptly and effectively. The language in the OSFI supervisory letters is carefully calibrated to reflect the nature of the required actions, distinguishing between those rooted in statutory powers and those based on supervisory expectations, guidelines or best practices. OSFI underscores the gravity of certain findings by copying additional recipients, such as the Chair of the Audit Committee or external auditors, on all supervisory letters to reinforce their significance.

65. **Some jurisdictions employ instruments that are not solely designed to address identified weaknesses but that can also be used for purposes such as investigating specific risk areas or assessing progress in implementing supervisory measures.** This is the case of the skilled persons report[22] in the UK, which enables supervisors to obtain an independent view where this would advance their objectives. As part of its approach to formal investigations, the PRA has recently introduced the Early Account Scheme and Enhanced Settlement Discount to expedite the investigative process and incentivise early admissions. Under these formal cooperation schemes, supervised institutions under investigation are given the opportunity to receive a substantial penalty discount in exchange for conducting a time-limited internal investigation and sharing the results. However, such cases are relatively rare and managed by specialised divisions within the PRA. A similar approach exists in Brazil, where the central bank may enter into administrative agreements with institutions that admit to regulatory violations, offering either a significant reduction or elimination of penalties.

66. **The design, selection and application of supervisory instruments are influenced by a range of interconnected factors, including culture, institutional context and legal frameworks.** Across jurisdictions, supervisors often emphasise moral suasion and informal tools as a first line of engagement, depending on the nature and severity of identified weaknesses. At the same time, the degree to which formal enforcement is used and the speed with which it is triggered vary depending on historical practices, supervisory culture and institutional capacity. Furthermore, authorities with well established supervisory traditions may rely on informal norms that are widely understood, while others may lean more on formal instruments to maintain clarity and consistency. Legal and regulatory constraints also determine the feasibility of enforcement actions. In jurisdictions with strong legal foundations and well defined escalation mechanisms, supervisors may readily deploy formal instruments, while others, facing legal limitations or higher burdens of proof, may find informal measures more practical.

Inventory of qualitative measures

67. **While supervisory authorities in various jurisdictions employ a range of qualitative measures, there are some notable gaps where regulators lack legislative support for taking specific actions.** In the EU, the ECB lacks the power to impose fines on individuals, as these remain within the jurisdiction of national authorities.[23] Moreover, more than half of the jurisdictions do not have an explicit law obliging supervisors to take early action in response to emerging risks. In the US, while the Prompt Corrective Action (PCA) framework provides a structured escalation of supervisory measures, its triggers are primarily based on capital thresholds, meaning that intervention only occurs once an institution's financial condition has already deteriorated. As a result, PCA does not function as a true early intervention

[22] The cost of the report is paid for by the bank and, depending on the PRA's level of confidence in bank management and the scope of the assessment, either the PRA chooses the consultant and the report is sent directly to the PRA, or the bank chooses the consultant from a pre-approved list of specialists and the report is sent first to the bank, which then shares it with the PRA.

[23] The ECB has the authority to impose financial penalties on significant banks that violate directly applicable EU law or ECB decisions or regulations. For breaches of national law implementing EU directives, infractions committed by natural persons or cases requiring non-financial penalties, the ECB may request that the relevant national competent authority (NCA) initiate appropriate proceedings. The NCA is responsible for conducting these proceedings and determining the applicable penalties in accordance with national law.

tool but rather as a response mechanism once financial weaknesses are evident. In compensation, US supervisors have broad authority under the concept of "unsafe and unsound" practices, which allows them to intervene in case of observed practices that deviate from prudent banking standards and that could threaten an institution's safety or solvency or the interests of depositors. Table 3 provides an inventory of qualitative measures that are available across sampled authorities.

68. **Among the various tools that facilitate the application of qualitative measures, only a few jurisdictions have adopted IARs.** Fully fledged IARs exist only in Australia, the UK and Singapore. However, some jurisdictions have adopted certain features of IARs. For example, the ECB's draft guide on governance and risk culture emphasises that banks should ensure that internal policies clearly define the roles and tasks of internal control functions and allocate responsibilities effectively across the three lines of defence (ECB (2024b)). Similarly, Canada has issued a guideline that outlines expectations for identifying and assessing "responsible persons", including directors, senior managers and branch management (for foreign bank branches) (OSFI (2008)).

Supervisory qualitative measures backed by explicit legal powers

Table 3

	Qualitative measures	Australia	Brazil	Canada	China	Singapore	EU (ECB)	UK	US
General	• Laws or regulations guard against the supervisor unduly delaying appropriate corrective actions		✓	✓	✓	✓	✓		
	• Individual accountability regime (IAR)	✓				✓*		✓	
	• Supervisory publications carry binding regulatory nature	✓			✓	✓		✓	✓
Reporting	• Require additional disclosures and targeted deep dives	✓	✓	✓	✓	✓	✓	✓	✓
	• Impose additional or more frequent reporting requirements	✓	✓	✓	✓	✓	✓	✓	✓
	• Order an external audit or third party review	✓	✓	✓	✓	✓	✓	✓	✓
Restoration	• Reinforce risk management processes	✓	✓	✓	✓	✓	✓	✓	✓
	• Require bank's plan to restore compliance with supervisory requirements	✓	✓	✓	✓	✓	✓	✓	✓
Restriction	• Restrict the current activities and operations of the organisation	✓	✓	✓	✓	✓	✓	✓	✓
	• Withhold or condition approval of new activities or acquisitions	✓	✓	✓	✓	✓	✓	✓	✓
	• Restrict or suspend payments to shareholders or share repurchases	✓	✓	✓	✓	✓	✓	✓	✓
	• Restrict asset transfers	✓	✓	✓	✓	✓	✓	✓	✓
	• Limit variable remuneration	✓	✓	✓	✓	✓	✓	✓	✓
Requirements	• Require additional capital, requiring plans to correct deficiencies	✓	✓	✓	✓	✓	✓	✓	✓
	• Impose specific liquidity requirements	✓	✓	✓	✓	✓	✓	✓	✓
Removal and retaliation	• Bar individuals from acting as controlling shareholders, officers or board members of financial institutions	✓	✓	✓	✓	✓	✓	✓	✓
	• Replace or restrict the powers of officers, board members or controlling shareholders	✓	✓	✓	✓	✓	✓	✓	✓
	• Remove an auditor	✓	✓	✓		✓	✓	✓	✓
	• Provide for the interim management of the bank	✓	✓	✓	✓	✓	✓	✓	✓
	• Impose fines on institutions	✓	✓	✓	✓	✓	✓	✓	✓
	• Impose fines on individuals	✓	✓	✓	✓	✓		✓	✓
	• Impose periodic penalty payments for institutions		✓		✓		✓	✓	
	• Confiscate profits generated illegally				✓			✓	
Revocation	• Revoke or recommending the revocation of the banking licence	✓	✓	✓	✓	✓	✓	✓	✓
	• Facilitate a takeover by or merger with a healthier institution	✓	✓	✓	✓	✓	✓	✓	✓
	• Ringfence a bank from other entities in its corporate group	✓		✓	✓	✓	✓	✓	
	• Liquidate/resolve the bank	✓	✓	✓	✓	✓	✓	✓	✓

* Singapore's IAR takes the form of Individual Accountability and Conduct guidelines (IAC GL) issued by MAS and should be read with a set of FAQs on the IAC GL, the relevant Acts and their subsidiary legislation, written directions, notices, codes and other guidelines that MAS might issue from time to time. Those IAC GL and FAQs apply to nearly all financial institutions supervised by MAS.

Composite ratings and qualitative measures

69. **Several jurisdictions have established links between supervisory risk ratings and potential supervisory actions.** Australia, Canada and the UK all operate a two-step process that first assigns a risk rating to a firm and then maps it to predefined "staging" categories, which outline potential supervisory actions at each stage. Of the three jurisdictions, Canada provides public guidance on how it maps its supervisory risk ratings to the various stages that may warrant supervisory actions.[24] China, which operates a six-level rating scale (1 being the best and 6 the worst), specifies in public guidance that supervisory actions begin for firms with a composite rating of 2 (good) and become increasingly more stringent as the composite rating deteriorates (3 or worse).[25] The US (OCC) operates a 1–5 rating scale (1 being the best and 5 the worst) and provides guidance on the circumstances of the types of supervisory action that may be considered for 1- and 2-rated banks (typically informal actions) and the presumption of certain types of increasingly stringent (and legally binding) supervisory action for 3- 4- and 5-rated banks (OCC (2023)). For the latter, it provides a publicly available booklet that serves as a key reference for its problem bank supervision policy, defining a problem bank as one with a composite rating of 3 or worse.

70. **The US FRB's LFI rating system is perhaps the most transparent in providing clear two-way links between ratings and the actions expected of a firm to address identified supervisory concerns.** Public guidance on the LFI rating system, which is based on a four-level scale, outlines the consequences for each assigned rating. It also links rating upgrades to a firm's ability to resolve and address identified supervisory concerns, while an inability to address supervisory concerns in a timely manner could result in a rating downgrade. See Box 1 for further details.

71. **However, transparency in linking risk ratings to supervisory actions varies across jurisdictions, reflecting different supervisory philosophies.** While Canada,[26] China and the US (OCC) provide a non-exhaustive public list of mappings between ratings and potential supervisory measures, others, such as the EU (ECB) and Singapore, do not make these linkages explicit, instead relying on internal guidance and supervisory discretion. Jurisdictions that emphasise clear linkages between risk ratings and supervisory actions aim to enhance consistency and predictability in supervisory interventions, ensuring that institutions understand the consequences of their risk profile. In contrast, those favouring a more flexible approach give more weight to case by case assessments, allowing supervisors to tailor responses to the unique circumstances of each institution.

72. **All jurisdictions emphasised the use of moral suasion as a key tool for addressing problems in a bank at an early stage when its overall risk rating remains satisfactory but qualitative shortcomings are observed.** Moral suasion allows supervisors to promptly convey identified supervisory issues to relevant bank officials in order to facilitate early corrective actions. Moral suasion is typically conveyed orally, and when documented in writing, it usually appears in unofficial formats, such as emails, rather than formal supervisory reports.[27] However, many authorities highlighted the value of the oral

[24] For example, Canada has adopted an eight-level rating scale (1 being the best and 8 the worst), and these ratings are mapped onto stages from 0 to 4. Ratings 1 to 4 are mapped to stage 0, which helps supervisors to better differentiate the relative riskiness of otherwise healthy banks and to take relevant supervisory actions. Ratings 5 to 8 are mapped to stages 1 to 4, respectively, with each stage signalling a more intrusive supervisory response. See OSFI (2024b) for further details.

[25] In practice, supervisors in China may escalate supervisory measures according to rating results, advancing from moral suasion to regulatory opinions and mandatory corrections.

[26] Canada's guide to intervention outlines a non-exhaustive list of supervisory actions for institutions rated through 8. See OSFI (2024b) for further details.

[27] The US OCC noted that in some cases it uses written moral suasion in CEO letters or in reports of examination in the form of comments (as opposed to recommendations). As noted previously, there is no expectation to act nor are there any consequences for failure to act on such written forms of moral suasion.

channel in building trust with senior bank management, since oral recommendations have an offline character and are not tracked by supervisors.

73. **Moral suasion is often used to convey supervisory concerns about business model sustainability, especially when a bank's financial metrics appear strong.** A few jurisdictions mentioned that moral suasion has been used to signal concerns about bank business models at an early stage,[28] without triggering defensive reactions from bank leadership. This informal dialogue helps nudge institutions towards proactive adjustments before financial deterioration sets in. However, its effectiveness depends on the supervisory culture and the strength of the relationship between supervisors and bank leadership. Some authorities acknowledged that moral suasion has limitations, including for example, that such recommendations may not necessarily be tracked by supervisors. In addition, banks that do not perceive supervisory concerns as urgent may be slow to act, leaving supervisors little choice but to escalate issues into written findings or formal measures. To manage this risk, a few jurisdictions track recurring supervisory discussions internally (ie meeting minutes), allowing them to identify persistent shortcomings and take timely action if needed.

74. **Supervisors also deploy a range of written informal supervisory actions to address qualitative weaknesses in otherwise healthy banks.** When the identified qualitative weaknesses are considered relatively significant, many authorities typically document their findings and suggest corrective actions in writing through informal actions, going beyond moral suasion. These actions allow supervisors to exert pressure while maintaining a cooperative relationship with bank management. Informal actions are non-binding; however, if they are not addressed to the supervisor's full satisfaction in a timely manner, they often serve as the basis for more severe, legally binding actions. In the US, the OCC utilises a range of informal supervisory tools to differentiate the relative severity of identified supervisory concerns in non-problem bank situations. Other authorities, such as the ECB, may use a single instrument – in this case an operational letter – but typically differentiate significance through the nature of the communication, prioritisation of findings or tone of the letter (see Section 6 for details).

75. **Only a few authorities provide guidance on the circumstances when moral suasion versus other informal supervisory actions should be used to address qualitative weaknesses in banks.** In the US, the dividing line appears to be whether supervisors classify their findings as "deficient practices" versus "recommendations". In regard to the former, the OCC's manual states that deficient practices are "practices or lack of practices that deviate from sound governance, internal control or risk management principles and have the potential to adversely affect the bank's condition, including financial performance or risk profile, if not addressed" (OCC (2023)). Deficient practices must be communicated to the bank in writing through some form of informal or formal action. In contrast, the OCC defines recommendations as "suggestions to enhance policies or as best practices" (OCC (2019)). As such, recommendations do not require specific action by bank management or follow-up by examiners; therefore, they can be provided informally to bank management.[29]

Governance and business model ratings and qualitative measures

76. **Governance assessments are inherently institution-specific, shaped by each bank's unique leadership structures, decision-making processes and internal dynamics.** All surveyed jurisdictions mentioned that shortcomings in governance and risk management must be evaluated in the context of

[28] These concerns include: (i) a bank pursuing an aggressive growth strategy in certain market segments, especially if risk controls are not keeping pace with planned growth; and (ii) risks to the longer-term viability of a bank's business model, even if the bank remains profitable in the near term.

[29] Under the OCC's policy, recommendations **cannot** be included in on-site inspection reports or other formal written communication to the bank (eg a supervisory letter) since no specific action by bank management is required.

an institution's particular circumstances.[30] Therefore, the specific nature of qualitative measures taken, including whether those measures are sought through informal or formal actions, is tailored to each bank.

77. **A common supervisory response to persistent governance deficiencies involves pairing qualitative measures with capital add-ons.** While all authorities acknowledge that capital add-ons do not directly resolve governance deficiencies, they serve as a powerful incentive for banks to strengthen governance frameworks, improve risk oversight and enhance board effectiveness. Several jurisdictions noted that capital measures are often used alongside qualitative action – such as requiring governance remediation plans or mandating board-level changes – to ensure a comprehensive response. This combined approach reflects the recognition that governance shortcomings are best addressed through structural and cultural changes within the institution, but financial consequences can accelerate the implementation of these reforms (Dahlgren et al (2023)).[31]

78. **Despite the idiosyncratic nature of governance deficiencies, authorities observed that certain qualitative features embedded in supervisory actions are consistently effective in achieving desired outcomes.** Several authorities mentioned the effectiveness of assigning board committees and/or specific (senior-level) individuals to oversee supervisor-imposed corrective action plans. In this context, both the UK and Australia noted the usefulness of their respective IARs as a "hook" to hold firms' relevant executives responsible for the delivery/resolution of each proposed supervisory action.[32] Some authorities also noted the benefits of requiring an independent third party to execute and/or oversee remediation measures.

79. **When governance and/or risk management shortcomings are severe, imposing restrictions on a firm's business activities or asset growth is effective.** Such an action gets the firm's attention, since it has a direct impact on profitability and long-term strategic planning. Given the severity of these measures, they must be supported by sufficient evidence. In the US, for instance, any qualitative measure that restricts a firm's business activities needs to be justified by an identified practice that is considered unsafe and unsound. Lifting these restrictions requires sustained improvements and demonstrable compliance with supervisory expectations. On this basis, in 2018 the US FRB placed an asset cap on Wells Fargo Bank, which remains in effect today.[33] The FRB's process for lifting the cap necessitates a formal vote by the Board of Governors and requires the bank to fully address supervisory concerns to the regulator's satisfaction.

80. **Replacing key leadership officials is another powerful supervisory tool for driving cultural and strategic change within a firm.** Authorities noted that seeking changes in board members and/or senior management has proven effective in transforming a firm's tone from the top. However, the burden of proof required to impose such measures is typically high. In the US context, a removal or prohibition action requires sufficient evidence to establish that the individual engaged in misconduct with the necessary level of culpability and that the misconduct resulted in financial loss to the institution or gain to the individual. In contrast, jurisdictions that have adopted IARs (Australia, Singapore, UK) should, in theory, have a lower threshold for seeking changes in a firm's senior executives, since relevant individuals can be

[30] These include supervisory views on the relative severity of the identified issues and whether the existing management team has the ability and willingness to correct problems on its own.

[31] A few jurisdictions also mentioned that, irrespective of any qualitative or quantitative measures, the governance rating itself (when the rating is disclosed to the bank), especially when it results in a downgrade or is low, sends a strong message, and banks are often keen to understand the reasons behind it so they can address the identified concerns.

[32] Australia noted that if poor outcomes are observed, supervisors expect to see a significant reduction in variable pay, among other levers, to hold senior executives to account.

[33] Another example is a cease and desist order issued by the OCC against Citibank in 2020 due to its failure to establish effective risk management, data governance and internal controls. Importantly, the order required the bank to seek the OCC's non-objection before making significant new acquisitions. See OCC (2020) for further details.

held to account for failings that occur under their watch if they did not take "reasonable steps" to prevent the noted deficiency from occurring. However, making a call on what constitute reasonable steps is inherently qualitative and can pose implementation challenges.

81. **Supervisory measures addressing concerns about the viability of bank business models are often quantitative in nature, with capital add-ons being the most frequently used response.** Most of the authorities that provide an explicit assessment of business models confirmed that the most common measure taken in response to a poor rating is to seek higher capital add-ons, followed by the requirement to improve relevant risk controls. The underlying rationale is that banks operating with a higher-risk business model require additional capital support and commensurate risk management controls. However, as previously noted, capital-based measures alone may not sufficiently address strategic weaknesses, especially those stemming from flawed business models. In some cases, excessively high capital requirements could even be counterproductive, as they may constrain a bank's ability to generate adequate returns for its shareholders, potentially exacerbating long-term viability concerns rather than resolving them. Several authorities acknowledged that while business model deficiencies can have profound long-term implications, seeking fundamental changes to a bank's strategy is challenging. Some authorities also feel less comfortable decisively interfering with banks' strategic direction, as they consider such decisions to be the purview of bank boards and senior management.

Section 6 – Communication of supervisory findings and monitoring and escalation

Communication of supervisory findings

82. **A consistent theme across jurisdictions is the emphasis on structured, well targeted communication as a foundation for effective supervision.** Whether through confidential assessments, structured engagement with boards or public enforcement actions, supervisors aim to ensure that banks clearly understand their risks and obligations. The challenge lies in striking the right balance between providing enough clarity to drive action without overwhelming institutions with excessive detail or being overly prescriptive and ensuring banks remain fully accountable for addressing identified supervisory concerns.

83. **Supervisory dialogue is the basis of effective communication**. In frameworks that rely on moral suasion, such as those seen in Singapore or the EU (ECB), supervisory assessments and ongoing supervision prompt iterative discussions between supervisors and banks. These exchanges allow both sides to explore identified weaknesses and assess their severity, ensuring that the bank's perspective is fully acknowledged. This constructive forum enables banks to articulate their challenges and discuss remediation plans while supervisors expand their understanding of the underlying issues.

84. **Supervisors also employ a variety of communication tools to convey their assessments, expectations and required actions.** These vehicles of communication vary in structure and frequency, yet they share the common goal of ensuring that banks remain sound, responsive to risks and accountable for addressing weaknesses. In many jurisdictions, every bank receives a comprehensive annual letter that summarises findings over a longer supervision period (typically spanning 12 to 18 months), complemented by ad hoc or interim letters issued after targeted on-site or desk reviews. For example, Canadian supervisors issue annual letters to all institutions, and OSFI also provides interim supervisory letters throughout the year whenever it considers that an issue requires attention. In exceptional cases, these interim letters can be issued within 24 hours to address urgent situations. Similarly, within the ECB, the Supervisory Review and Evaluation Process (SREP) decision serves as the central legal document for a 12-month supervision cycle, with additional operational acts issued as weaknesses are identified. Meanwhile,

the UK PRA maintains ongoing engagement with its largest banks by sending out up to 15 to 20 supervisory letters throughout the year, with the PSM letter serving as the central communication tool.

85. **A primary objective of supervisory communication is to confirm and clarify an institution's risk profile.** Many supervisors issue structured, periodic communications that summarise their assessment of a bank's financial condition, governance and risk management over a supervision cycle. These communications not only provide a risk rating but also detail the key drivers behind the assessment and, where necessary, offer principles-based guidance on improvements. For instance, some jurisdictions include supervisory observations on industry-wide themes and supplementary components such as tables of open issues (with due dates and status) and supervisory plans for the upcoming year. In Canada, the annual supervisory letter includes outcome statements that describe at a high level what an institution needs to address to improve its current rating. Canada typically limits the number of outcome statements to the three most important issues that pose a threat to a bank's financial viability or critical operations. The annual supervisory letter also includes appendices that summarise the number of open and overdue findings and related action items as well as the interim supervisory letters issued in the past year.

86. **Supervisory communications also play a critical role in setting clear expectations for corrective action, ensuring that banks are not only aware of their weaknesses but also understand the steps required for remediation.** In some jurisdictions, banks are expected to propose their own corrective action plans in response to supervisory findings, as seen in Australia's model, in which banks draft remediation proposals that are then reviewed by the regulator. Similarly, in Singapore, discussions with banks focus on clearly communicating the relative importance of individual findings; after an examination, banks provide an examination response that details whether they agree or disagree with the findings, outlines next steps and commits to specific timelines. Singapore's prudential authority, the Monetary Authority of Singapore (MAS), then evaluates these proposals to ensure they align with supervisory expectations. Elsewhere, supervisors provide more prescriptive guidance, either by explicitly outlining required actions or through outcome statements that condition risk rating improvements on the implementation of the prescribed corrective measures. In jurisdictions like the US (OCC)[34] and the EU (ECB), supervisors benefit from detailed handbooks and specialised training designed to ensure that their findings and corrective measures are drafted effectively.

87. **To ensure that institutions focus on the most pressing issues, many supervisors have shifted from lengthy, detailed reports to a more streamlined approach that highlights only a handful of key areas of concern.** In the UK PRA's methodology, the PSM letter typically consolidates the top three key findings as focal areas for corrective action. These top findings not only represent the most critical weaknesses identified but are also accompanied by specific actions and timelines that banks are expected to follow. Following a similar logic, the ECB is reviewing its SREP decision-making process to ensure that the most severe supervisory concerns and the drivers of corrective measures are effectively captured and acted upon, in line with the recommendations received by the ECB following the 2023 review of its risk assessment process (Dahlgren et al (2023)). Jurisdictions that previously dealt with an extensive "laundry list" of supervisory expectations have found that a more focused approach leads to better prioritisation and follow-through.

88. **Effective governance and accountability further underpin supervisory communication.** Many supervisors require that their findings be reviewed at the highest levels of a bank's governance structure, ensuring that boards of directors remain fully aware of supervisory concerns. For example, authorities such as Canada's OSFI instruct the bank to share supervisory letters with the board and the external auditor. The UK PRA's PSM letter is addressed to the bank's board, signed by the Executive Director of Supervision (for large banks) and supported by a presentation to the bank's board (often led by the Deputy Governor for the largest banks), underscoring the gravity of the message. In instances where

[34] The OCC's bank supervision process manual, which is publicly available, provides a structured methodology for supervisors to articulate deficiencies, identify root causes, assess risks and specify required remediation steps. See OCC (2019) for details.

banks fail to implement corrective measures, supervisors may escalate concerns further by involving enforcement divisions or resorting to more formal intervention measures.

Disclosure of supervisory ratings

89. **Risk rating disclosures to banks vary across sampled jurisdictions.** While most surveyed jurisdictions (seven of eight) disclose the overall composite rating assigned to a firm, only a few disclose component ratings that are assigned for governance and business models (Table 4). In general, jurisdictions that disclose composite and, in some cases, component ratings stressed the benefits, such as helping banks' senior management and boards to focus on areas of supervisory concern that warrant immediate corrective measures. Some also mentioned that rating disclosures provide banks with greater clarity on the steps needed to improve their risk ratings. Other jurisdictions argued that supervisory rating disclosures often lead bank management to focus excessively on the numerical rating rather than the underlying issues driving that rating. These jurisdictions also emphasised that such concerns may be heightened for component ratings that are largely reliant on qualitative factors, such as governance and business models (if rated), resulting in unproductive discussions on how the score is derived instead of on the key supervisory findings that influence the score.

Disclosure of supervisory risk ratings to banks

Table 4

	Disclosure of composite/overall rating?	Disclosure of governance rating?	Disclosure of business model rating?
Australia	✓	–	–
Brazil	✓	–	✓
Canada	✓	✓	✓
China	✓	✓	NA
Singapore*	✓	✓	NA
EU (ECB)	✓	✓	✓
UK	–	–	–
US	✓	✓	NA

✓ Applicable; – Not applicable.

NA: Business model viability not rated on a standalone basis.

(*) Disclosures applicable only to large firms.

Source: Publicly available information in national regulation and/or discussions with supervisors.

90. **When binding supervisory measures are issued, some authorities make these actions public**. In the US, banking regulators publicly disclose enforcement actions against specific banks, providing detailed descriptions of deficiencies and required corrective measures. These disclosures, available on regulatory websites, include cease and desist orders, civil money penalties and consent orders, ensuring that both market participants and the public are aware of supervisory concerns and the actions taken to address them. Various other jurisdictions also disclose binding supervisory actions with varying levels of specificity (Table 5).

Public disclosure of binding supervisory actions*	Table 5
Australia	✓
Brazil	✓
Canada	–
China	✓
Singapore**	✓
EU (ECB)	–
UK	–
US	✓

✓ Applicable; – Not applicable.

(*) Binding actions refer to those that are backed by statutory provisions in law or regulation. All other supervisory actions, such as suggestions/recommendations or those considered informal in nature, are not covered within this column.

(**) MAS publicly discloses supervisory actions on a case by case basis. In deciding whether to make the public disclosure, MAS exercises supervisory judgment in assessing whether public disclosure of supervisory actions is warranted.

Monitoring and escalation

91. **Monitoring allows supervisors to track the implementation of corrective actions and serves as the basis for escalating with more severe measures where needed.** A key component of the monitoring process requires supervisors to assess a bank's progress in addressing identified weaknesses and executing remediation measures within pre-established time frames. This vigilant oversight process provides the flexibility to intervene swiftly when measures prove ineffective, enabling supervisors to escalate issues to more stringent enforcement actions if necessary.

92. **Enhanced IT capabilities are used to track corrective measures.** In many jurisdictions, supervisory agencies have ramped up their technological infrastructure to gain a comprehensive overview of the status of corrective actions (eg new, repeat, past due, escalated etc). Once issued, corrective measures typically include a detailed description of the deficiency, an agreed-upon remediation plan and a specific timeline, with severity differentiated so that top priorities are addressed in a risk-based manner. Given the high volume of such measures, technological support becomes essential for tracking whether implementations are on track, delayed or fully completed. For example, the ECB employs a common platform that integrates all relevant supervisory processes dictated by risk assessments, while additional tools – such as dashboards and advanced search capabilities with textual analysis – further support supervisors in analysing findings and monitoring progress.

93. **Supervisors must exercise reasoned judgment when deciding whether to escalate, recognising that it can take time to implement corrective actions effectively**. In large banks, delays often stem not from inaction but from the need to complete final validation steps such as internal audits or supervisory verification. In the US, when an institution has largely addressed an issue but is awaiting final confirmation, supervisors may opt not to escalate provided there is a clear justification documented in a non-escalation memo. In Australia, the primary focus is on ensuring that corrective measures are being implemented effectively. Meanwhile, in the UK, the PRA assesses whether delays reflect a more complex underlying issue before escalating. However, if a bank is uncooperative and refuses to take action, escalation remains a necessary step.

94. **Supervisory authorities use internal guidance to ensure consistency and proportionality in escalation decisions.** The ECB differentiates between non-legally enforceable findings and unimplemented (legally binding) SREP supervisory decisions, tailoring its response accordingly and reporting the latter to enforcement and sanctions teams. The US (OCC) has also established escalation

procedures applicable to large banks with consolidated assets of $50 billion or more. When a large bank exhibits "persistent weaknesses",[35] the OCC may escalate to formal enforcement actions in order to reinforce its supervisory objectives.

95. **Supervisors use committees and structured processes to assess potential escalation decisions, ensuring consistency and scrutiny.** In Canada, the Entity Rating Panel (ERP) can be convened when necessary, bringing together three senior members to review supervisory findings and assess whether a rating change or escalation is warranted. While the ERP functions as an advisory body rather than a decision-making entity, its role is to provide expert input and challenge supervisory judgments before final decisions are made at higher levels, such as the Deputy Superintendent or Executive Director. Many other jurisdictions also have similar internal processes to support escalation decisions.

96. **Across jurisdictions, legal challenges to supervisory actions cause delays and uncertainties, making escalation through enforcement a complex – though necessary – tool.** When banks contest corrective measures in court, the process can be prolonged and costly. In the US, most banks opt to consent to cease and desist orders rather than face court proceedings, which can take at least 18 months[36]. In Australia, the Australian Prudential Regulation Authority (APRA) strengthened its enforcement approach following a review, emphasising a more assertive stance. However, if a firm challenges APRA's decision in court, the action could be suspended until a decision is made, unless APRA is able to make a strong case for immediate application.

97. **Ensuring the proper closure of supervisory findings requires a structured approach that often involves both internal audit validation and direct supervisory verification.** In Canada, institutions often engage their internal audit teams and submit audit reports for review, with follow-up documents tracking the process. If closure expectations are not met, supervisors will consider banks' progress in addressing supervisory findings, including adherence to agreed-upon timelines, and adjust supervisory ratings if warranted. In the US, while internal audits play a role, supervisors do not rely solely on internal audit validations and conduct independent validations to verify that all reported findings have been fully addressed. Singapore relies on internal audit functions to validate corrective actions but may also conduct follow-up checks or incorporate past findings into future inspections to ensure full resolution.

Section 7 – Initiatives to strengthen supervisory effectiveness

98. **As the preceding sections indicate, the use of qualitative measures hinges on the robust application of a chain of related yet distinct supervisory activities that comprise the supervisory process.** The manner in which supervisory teams implement each step of the supervisory process – which includes planning/risk scoping, risk assessment, communication, and monitoring and escalation – has a significant bearing on whether to impose qualitative measures, as well as their type and severity. In all jurisdictions, how supervisors carry out various steps of the supervisory process is guided by: (i) the existing set of jurisdiction-specific supervisory tools, rating systems, methodologies, guidance and processes that support implementation; and (ii) the depth and breadth of supervisory teams' expertise and their ability to exercise judgment on qualitative issues that are often "shades of grey".

99. **A range of supervisory initiatives can be considered to enhance the use and effectiveness of qualitative measures.** The proposed supervisory initiatives noted below touch upon each element of

[35] Persistent weaknesses may include deficiencies that are severe, uncorrected, repeated, unsafe or unsound, or negatively affecting a bank's condition. See OCC (2023) for details.

[36] A significant legal challenge is currently under way in the US against the FRB's use of stress test tools. Several stakeholders have filed litigation contesting the lack of transparency in the stress testing framework. They argue that the opaque regime, combined with the absence of clear standards for the global market shock and the operational risk charge, results in inaccurate, volatile and excessive capital charges. See ABA (2024) for details.

the supervisory process, identifying certain attributes that may merit consideration. These recommendations are drawn from specific features noted in sampled jurisdictions' supervisory frameworks and the authors' own analysis. There is no "quick fix" to enhance supervision, and actions may be required on multiple fronts to address the complex set of factors that influence supervisors' capacity to act based on their qualitative findings.

Risk scoping

- **Establish own risk appetite framework, clarifying the level of risk the supervisory authority is willing to accept in its oversight approach:** Given finite resources and competing priorities, no supervisory plan can cover every risk area with equal intensity; instead, supervisors must focus on the most pressing risks while accepting that some areas may receive less attention. A well defined risk appetite framework enables banking supervisors to prioritise effectively, allocate resources efficiently and justify their supervisory focus both legally and reputationally. While supervisory judgment may not always be perfect, a transparent risk appetite framework provides a structured basis for decision-making and accountability.
- **Combine top-down and bottom-up approaches in determining bank-specific supervisory plans:** The top-down approach reflects supervisory authorities' key priority areas for the banking sector; these priority areas form the basis on which horizontal risk assessments are conducted during the supervisory cycle, facilitating benchmarking across firms and informing the agency-wide view of risk in the designated focus areas. Publication of system-wide supervisory priorities with a sufficient level of detail facilitates transparency and can help banks understand and align with supervisory expectations. The top-down approach should be augmented with a bottom-up assessment of bank-specific risks when formulating the supervisory plan for a bank.
- **Develop safeguards for bottom-up assessments to ensure that sufficient supervisory work is planned in important qualitative areas that could affect a firm's overall risk profile:** One approach would be to require a baseline level of transaction testing to validate key risk control systems during each supervisory cycle, even if the areas are judged to be low-risk and would otherwise be either out of scope or subject to limited scrutiny. Similarly, as an institution's systemic footprint increases, the risk scoping methodology should require more granular risk assessments of governance and risk management functions (as required in Australia and Canada) in order to ensure that supervisory work planned in qualitative areas keeps pace with the firm's significance. These approaches should be overlaid with an independent internal quality assurance process – staffed by experienced supervisors – that provides an additional layer of scrutiny to confirm that bank-specific risks are appropriately considered in supervisory plans.

Risk assessment

Rating system architecture

- **Place greater emphasis on qualitative elements in supervisory rating systems:** For reference, the US FRB places a heavy emphasis on the qualitative elements of all three of its LFI rating system components, ensuring that any significant shortcoming in governance or risk management drives the nature and severity of supervisory actions. Another approach could be to place greater weight on the governance assessment in relation to any other component rating (as done in China) or to establish a rating system which stipulates that the overall rating assigned to a firm can be no better than the firm's governance rating. These approaches not only encourage supervisors to allocate sufficient resources to relevant qualitative areas during the risk scoping phase, but also prompt them to address deficiencies early, ensuring that the root causes of broader risk issues are effectively targeted.

- **Introduce a weakest link approach in supervisory rating systems:** A few jurisdictions (Australia, Canada) have adopted a weakest link approach, whereby a poor rating/score in any one component drives the overall rating assigned to a firm. This approach ensures that qualitative weaknesses in one area (eg governance), provided they are deemed significant, cannot be diluted by a strong score in another element (say capital or liquidity). Such a methodology can help to shine a spotlight on fundamental deficiencies that may warrant qualitative measures and that may not otherwise be transparent when assessing a firm's consolidated risk profile.
- **Establish a stand-alone component rating for business model sustainability:** When business models are assessed as a standalone component, deficiencies have a direct impact on the overall rating, making weaknesses immediately visible and potentially triggering applicable supervisory measures at an earlier stage. Some jurisdictions assess business models based on an evaluation of a bank's strategy, capital adequacy, liquidity position and profitability. Others assess business models independently of assessments related to capital and liquidity. There may be merits to the latter approach, as it prompts supervisors to analyse strategic soundness and long-term viability without linking them to financial resilience metrics.

Toolkits that support governance and business model assessments

- **Develop red flags or similar guidance to support assessments of governance and risk management:** Supervisory assessments of governance and risk management are largely qualitative in nature, especially when the effects of a firm's weak oversight or poor practices have not yet manifested in financial metrics. The publication of qualitative red flags that may suggest weaknesses in board, senior management or risk management oversight, or practical examples of good practices for governance and culture, can help supervisors identify and take appropriate qualitative measures at an early stage.
- **Consider the merits of introducing IARs to support supervisors' ability to hold senior officials to account for lapses in governance and risk management:** IARs, which have been adopted in Australia, Singapore and the UK, facilitate the supervision of individual accountability of senior executives by: (i) making it possible to identify the senior executives responsible for specific business areas and functions; and (ii) holding them accountable for failings that occur under their watch if they did not take reasonable or adequate steps to prevent material breaches or failings from occurring or continuing once detected. In short, the concept of "reasonable steps" provides a hook for accountability.
- **Formulate heightened governance and risk management standards for significant banks to support supervisory risk assessments:** While all jurisdictions expect large and/or complex firms to have more sophisticated governance and risk management standards than smaller banks with a simple balance sheet, authorities expect supervisory teams to make assessments and take relevant qualitative measures as needed. To facilitate supervisory risk assessments, it may be helpful to prescribe, through regulation or supervisory expectations, what constitutes "heightened governance and risk management standards". The US OCC is one authority that has developed such guidance, making it easier for supervisors to identify gaps and take qualitative measures when firms fall short.
- **Further develop methodologies to enhance supervisory assessments of business model viability:** Supervisory methodologies regarding bank business models are still evolving. At the same time, there remains some ambiguity around the role supervisory assessments of a bank's business model should play in altering a firm's strategy. Against this backdrop, there may be opportunities for authorities to develop further guidance, in particular on methodologies/red flags that may serve as indicators of unsustainable business models, regardless of a firm's financial metrics. For publicly traded banks, one such indicator could consider the market value

of a firm's shares (share price) as a percentage of their book value.[37] Authorities can also consider the merits of using mark-to-market accounting values to calculate alternative measures of key solvency ratios as another means of assessing business model viability. The use of forward-looking scenario analysis can also assist supervisors in challenging management on key business plan assumptions and related strategies.

Supervisory actions and qualitative measures

Nature of qualitative measures

- **Engage with relevant bodies to seek additional powers, where lacking:** Supervisors must be equipped with the full range of qualitative measures to address the nature and severity of identified qualitative weaknesses. Some jurisdictions do not have authority to impose financial penalties on individuals or must meet an exceptionally high bar to seek changes in boards or senior management, among other limitations. Gaining the full suite of powers to address qualitative weaknesses in banks may require dialogue with and action from legislative bodies.
- **Attach responsibility for implementing supervisory actions to specific individuals and/or board subcommittees:** Regardless of differences in supervisory frameworks and cultural norms, the number of sampled authorities who noted the tangible benefits/success rate of supervisory actions when requiring that such actions be overseen and adhered to by specific senior bank executives, board subcommittees or third parties, as opposed to assigning collective responsibility to the entire board or bank, is striking.
- **Consider developing a "menu of options" approach to address concerns about the viability of bank business models:** To date, the most common measure taken in response to a poor business model rating is to seek higher capital add-ons, followed by the requirement to improve relevant risk controls. As noted earlier, capital-based measures are unlikely to address strategic weaknesses stemming from flawed business models and can potentially be counterproductive. Therefore, it may be desirable for authorities to consider developing a range of potential qualitative measures for use by supervisors that fit the nature and severity of the identified strategic/business model deficiency.
- **Make full use of severe qualitative measures, such as business restrictions and asset caps and replacement of key senior officials, as circumstances warrant**: Several authorities noted the effectiveness of such measures, but also highlighted the high bar that must be met to impose such sanctions. If regulated firms are aware that supervisory authorities are equipped with and have used such powers (as needed), it can serve as a powerful deterrent to compel banks to change their own behaviour without resorting to such drastic measures.

Methods of signalling the severity of qualitative measures

- **Establish links between supervisory risk ratings and potential supervisory actions:** Several jurisdictions outline clear mappings between ratings and potential (non-exhaustive) supervisory measures in published documents. This approach fosters transparency and sets clear expectations for institutions, enhancing predictability in supervisory interventions, while reinforcing the importance of supervisory risk ratings. The FRB's LFI rating system provides a two-way link between assigned risk ratings and the actions expected of firms to address noted supervisory concerns. That is, upgrades or downgrades to risk ratings are attached to a firm's

[37] Price-to-book value is the ratio of the market value of a company's shares (share price) over its book value of equity. Any ratio of less than one means that stock investors are attaching a lower market value of a bank's share in relation to the firm's stated book value. There may be many explanations for this, but one potential reason could be that market participants have some concerns regarding a firm's business model.

ability or inability to address supervisory actions in a timely manner. This two-way link may be a useful reference for authorities.

- **Consider mechanisms for differentiating the relative severity of identified qualitative findings:** Some jurisdictions, such as the US, use different supervisory instruments to convey the relative severity of identified findings. This approach reduces ambiguity to banks and provides a clear signpost of stronger supervisory actions if the identified concerns are not addressed in a timely manner. In other jurisdictions, the supervisory letter is the primary vehicle for communicating supervisory findings; in those cases, supervisors use other mechanisms, such as tone, frequency and addressees (eg more senior officials copied on the letter), to signal the relative severity of identified qualitative shortcomings. Both approaches work, although the former is more clear-cut.
- **Develop guidance to help supervisors determine when moral suasion versus other informal supervisory actions should be used to address qualitative weaknesses in banks:** Moral suasion was cited by all authorities as a key and effective tool for addressing qualitative concerns at an early stage. Nevertheless, it can lead to delayed actions if moral suasion proves unsuccessful. A few authorities (US-OCC) have developed publicly available guidance on when it is most appropriate to use moral suasion versus other forms of written informal actions to provide guidance and consistency in supervisory decision-making.

Supervisory communication

- **Deliver supervisory messages to key decision-makers in a structured, predictable and clear manner to maximise effectiveness:** Banks are more likely to take action when communication is concise, prioritised, issued at appropriate intervals and addressed to senior-level decision-makers. Adopting a tiered approach – using annual letters for broad issues and interim or urgent letters for time-sensitive concerns – has proven to be effective for many supervisory authorities. Excessive detail can overwhelm institutions, and prioritising key areas of supervisory concern with specific action points or outcomes can facilitate a timely response.
- **Disclose composite and component risk ratings, including rating definitions, to banks and consider making public formal enforcement actions:** Rating disclosures, including the definitions of each rating level, provide banks with greater clarity on the steps needed to improve their risk ratings and benchmark their performance against regulatory expectations. While most sampled jurisdictions disclose the composite rating, only a few disclose ratings for governance and business models. Given that these two component ratings are often leading indicators of a firm's future risk profile, such disclosures may facilitate open discussions on the root cause(s) that drive(s) assigned ratings and may propel banks to address the noted weaknesses.

Monitoring and escalation

- **Allocate supervisory resources to monitor banks' adherence to corrective measures and leverage IT capabilities for tracking purposes:** Supervision must go beyond identifying deficiencies to include rigorous tracking that confirms that banks are executing corrective actions effectively, sustainably and within required timelines. Adequate IT systems are needed to support supervisory monitoring of corrective actions, in particular those that are past due or incomplete. Some jurisdictions utilise technology-driven solutions such as dashboards, automated alerts and AI-driven textual analysis to enhance monitoring, streamline reporting and assess whether further escalation is needed.
- **Develop internal guidance and quality assurance processes to facilitate timely, consistent and proportional escalation decisions:** Supervisors must assess whether delays in corrective

actions are reasonable or if they signal a lack of commitment, warranting escalation. Applying an "escalate or explain" approach can enhance transparency and accountability, ensuring that unresolved high-risk deficiencies trigger immediate formal measures. Internal escalation frameworks (including supervisory guidance), combined with cross-functional committees and review panels, can strengthen oversight and improve the credibility of escalation decisions.

- **Ensure that corrective actions are fully implemented and independently verified before closing supervisory issues:** Adopting a structured verification process in which low- to medium-risk findings can be closed by banks' internal audit functions while more critical issues remain under supervisory oversight for final closure reduces the resource burden on supervisors, allowing them to focus on the most significant risks. Integrating past findings into future supervisory reviews prevents deficiencies from resurfacing due to weak implementation.

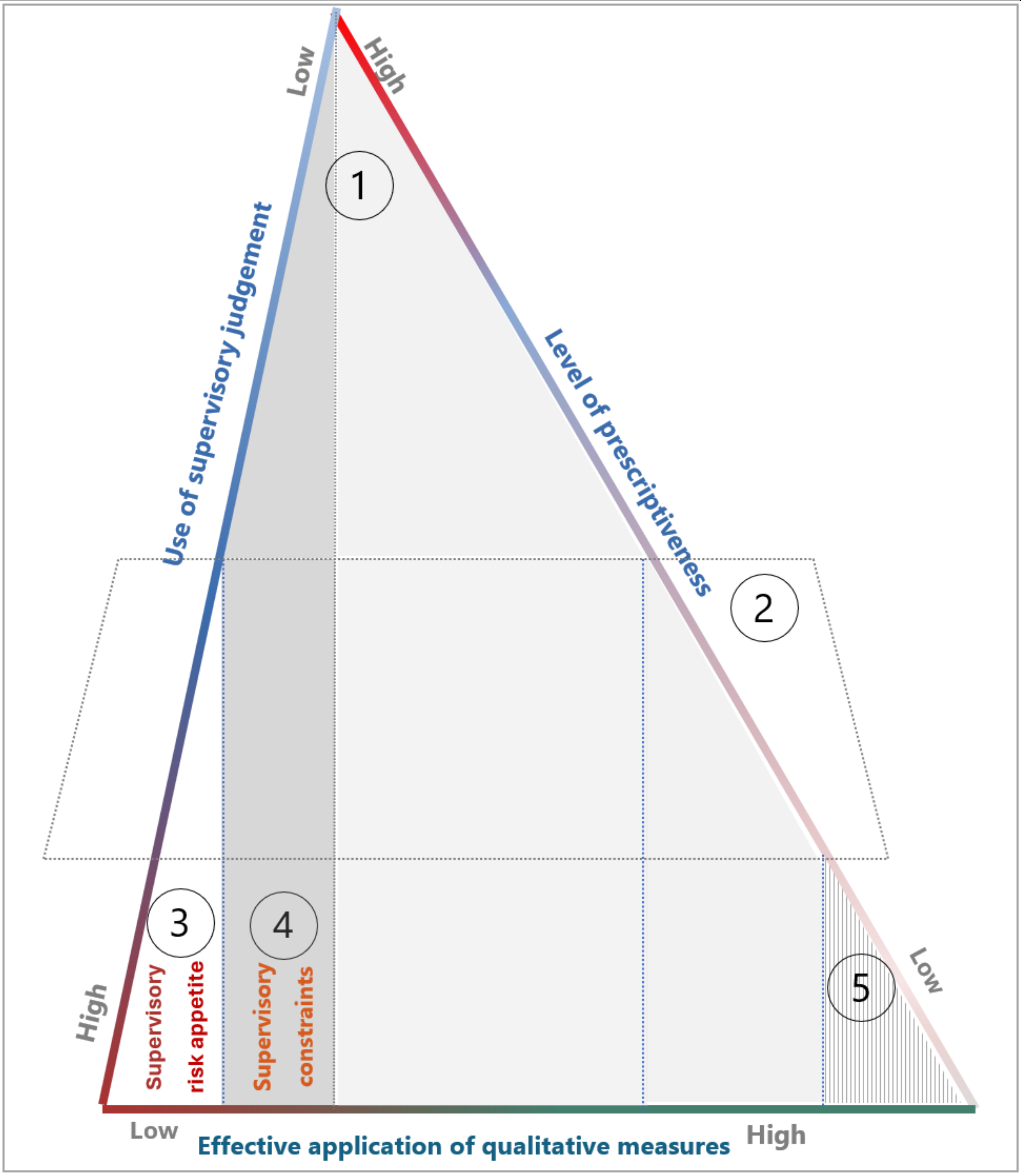
Supervisory judgment

- **Continue to foster sound professional judgment of frontline supervisors:** In-house training programmes, using real-life case studies that seek to replicate the nuanced judgments involved in day-to-day supervision, can support the development of supervisory judgment. In addition, training supervisors to recognise when to think fast – using pattern recognition and experience to respond quickly to urgent risk situations – and when to think slow – engaging in deliberate, analytical and structured decision-making for complex supervisory cases – encourages critical thinking.[38] Supervisors could be trained to identify biases that may affect their assessments, such as overconfidence or anchoring, which can lead to misjudgments of risk.
- **Strike an appropriate balance between rules and discretion in supervisory frameworks:** While rules provide structure and consistency, judgment allows for flexibility, ensuring that supervisory actions remain risk-based and proportional. Graph 4 maps levels of prescriptiveness against the use of supervisory judgment and their link to the effective application of qualitative measures. This triangle provides a framework for determining the right balance between prescriptive rules and supervisory judgment. Ultimately, jurisdictions must assess their supervisory resources and risk appetite to calibrate their approach effectively.
    - The "sweet spot" (Zone 2) blends structured frameworks with active supervisory discretion. This allows supervisors to adapt to emerging risks while maintaining consistency and effectiveness, essential in complex financial environments where rigid rules may fall short.
    - Conversely, a highly prescriptive approach (Zone 1) provides a safe and structured framework but may struggle with novel risks and could also hinder/discourage advancements in governance and risk management practices.
    - Among supervisory frameworks that rely heavily on judgment with relatively low levels of prescription (Zones 3, 4 and 5), the most promising are those in Zone 5, which have supporting risk appetite frameworks (eg willingness to tolerate the consequences of risk-based decisions) and no supervisory roadblocks. Even so, such frameworks require strong institutional capacity, experienced supervisors and clear governance frameworks to avoid inconsistency and to minimise the consequences of wrong decisions.
    - Authorities that rely heavily on supervisory judgment and fall in Zones 3 and 4 may be hampered, respectively, by: (i) incompatible risk appetite frameworks (eg low tolerance for risk-based decisions); or (ii) a multitude of supervisory constraints. In fact, those that fall within Zone 4 will face challenges regardless of the approach taken.

[38] For further details, see Daniel Kahneman's book *Thinking, fast and slow* (Kahneman (2011)).

The fine line between rules and judgment

Graph 4



Section 8 – Conclusions

100. **The March 2023 banking turmoil highlighted significant deficiencies in banks' governance practices and the viability of their business models, underscoring the critical need for timely qualitative measures.** All of the banks affected by the turmoil faced a crisis of confidence and, eventually, catastrophic liquidity runs, despite meeting applicable capital and liquidity requirements. These events

indicate that no feasible amount of quantitative requirements can compensate for qualitative weaknesses that stem from poor board oversight, flawed risk management and unsustainable business models.

101. **A broad range of supervisory policy initiatives that target key elements of the supervisory process can enhance the use and effectiveness of qualitative measures.** A multifaceted approach – rather than piecemeal one – is needed to address all of the potential factors that can affect the quality of supervision, including the propensity of supervisors to take timely qualitative measures. For this reason, each distinct yet interconnected step of the supervisory process – risk scoping, risk assessment, supervisory actions, communication and monitoring/escalation – is paired with proposed action points to foster and, in some cases, embed greater use of qualitative measures in supervisory frameworks and supporting implementation tools.

102. **These initiatives are ultimately premised on the ability and will of supervisors to exercise judgment.** In all jurisdictions, finding the right balance between judgment and prescription is context-driven, requiring a tailored approach. Yet, nuanced supervisory judgment remains indispensable, especially in evaluating governance and business models, where actions are expected to be taken against qualitative weaknesses before they manifest in a firm's financial metrics. As Ernest Hemingway bluntly put it: "How do you go bankrupt? Gradually and then suddenly." (Hemingway (1926)). Bank failures or problem banks do not appear in isolation; they are often the result of cumulative behaviours, decisions, actions and inactions by a bank's leadership. The universal challenge for all supervisors is to detect and take action on those qualitative weaknesses during the "gradual" phase. The stability of the banking system hinges on their ability to do so.

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