

Academic year 2017/2018

International Banking and Capital Markets II

*Lesson 19*

*Risk Appetite Framework (RAF) and  
Risk Appetite Statement (RAS)*

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## About last lessons



<https://www.youtube.com/watch?v=hwp6NsDZo3c>

## Introduction

*“Children sometimes eat too much. Their eyes can be bigger than their stomachs. The result can be quite unpleasant. For banks, it’s much the same. They sometimes take on more risk than they can stomach. The results, however, can be worse than just a bellyache. Banks that take on too much risk can get into financial trouble and fail, and, in some cases, they might even damage other banks and the economy. So banks must know how much risk they can stomach and set their appetite for risk accordingly”*

**Danièle Nouy**, Chair of the Supervisory Board of the ECB,  
International Conference on Banks’ Risk Appetite Frameworks  
Ljubljana, April 10<sup>th</sup> 2018

## 1. Principles for Risk Appetite Framework

November 2010

**SIE report**

→ The FSB, in consultation with the IMF, released in November 2010 a **report on Intensity and Effectiveness of SIFI Supervision (the SIE report)** which set out **32 recommendations primarily aimed at SIFIs**, but there were lessons for the supervision of financial institutions more generally. Leaders at the November 2010 G20 summit endorsed the policy recommendations contained in the SIE report and reaffirmed that the new financial regulatory framework must be complemented with more effective oversight and supervision.

October 2011

**SIE progress report**

→ The **FSB Supervisory Intensity and Effectiveness (SIE) group published a progress report** which noted that effective, measurable and actionable risk appetite frameworks have not yet been widely adopted by financial institutions. It concluded that **the development of an effective risk appetite framework needs attention by both firms and supervisors** and recommended that supervisors should discuss expectations for what a "good" risk appetite framework entails and how to supervise against these expectations.

## 1. Principles for Risk Appetite Framework

February 2013

**Thematic  
peer  
review**

→ FSB launched a **peer review on risk governance**. Based on the findings of the review five recommendations were set out, one of which asked the FSB to develop, in collaboration with relevant standard setters, guidance on the key elements contained in an effective RAF. **The report also recommended the FSB to establish common definitions for terms used in RAFs to facilitate communication between supervisors and financial institutions, as well as within financial institutions**

### Principles for an Effective Risk Appetite Framework

November 2013 The FSB Principles set out key elements for: (i) an **effective risk appetite framework**, (ii) an **effective risk appetite statement**, (iii) **risk limits**, and (iv) **defining the roles and responsibilities of the board of directors and senior management**.

## 1. Principles for Risk Appetite Framework

### Risk Appetite Framework

The **overall approach**, including policies, processes, controls, and systems through which risk appetite is established, communicated, and monitored. It includes a risk appetite statement, risk limits, and an outline of the roles and responsibilities of those overseeing the implementation and monitoring of the RAF. The RAF should consider material risks to the financial institution, as well as to the institution's reputation vis-à-vis policyholders, depositors, investors and customers. The RAF aligns with the institution's strategy.

The **articulation in written form of the aggregate level and types of risk that a financial institution is willing to accept, or to avoid, in order to achieve its business objectives.**

### Risk Appetite Statement

It includes a risk appetite statement, risk limits, and an outline of the roles and responsibilities of those overseeing the implementation and monitoring of the RAF. The RAF should consider material risks to the financial institution, as well as to the institution's reputation vis-à-vis policyholders, depositors, investors and customers. The RAF aligns with the institution's strategy.

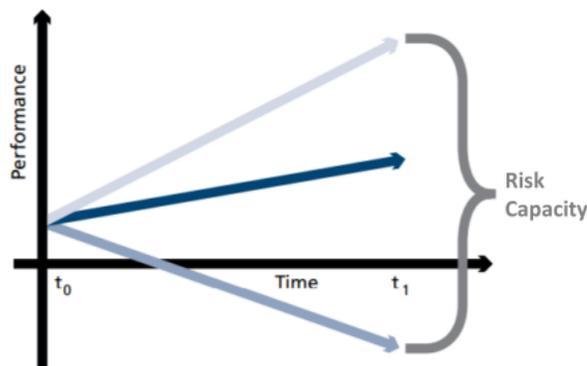
### Risk Profile

**Point in time assessment of the financial institution's gross** and, as appropriate, **net risk exposures** (after taking into account mitigants) **aggregated within and across each relevant risk category based on forward looking assumptions.**

## 1. Principles for Risk Appetite Framework

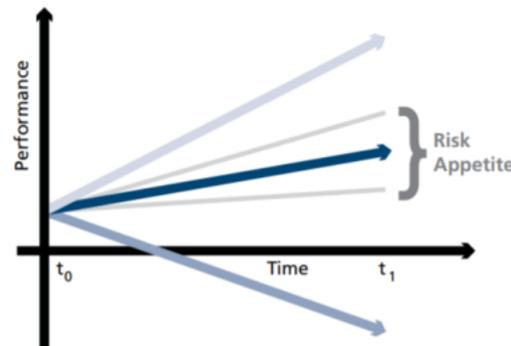
### RISK CAPACITY

The **maximum level of risk an institution is able to assume** given its capital base, its risk management and control capabilities, and its regulatory constraints



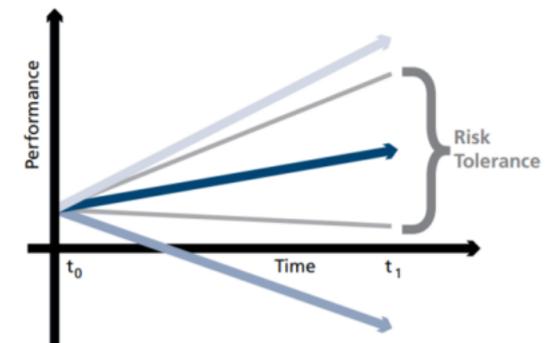
### RISK APPETITE

The aggregate level and types of risk an institution **is willing to assume** within its risk capacity, in line with its business model, to achieve its strategic objectives.



### RISK TOLERANCE

**Maximum deviation** from the permitted risk appetite, set in such a way as to ensure in any case the bank sufficient margins to operate within its own risk capacity



As provided by the FSB, the terms “**risk appetite**”, “**risk tolerance**”, and “**risk limits**” can be used by authors with slightly different meanings, so we use different terms from the FSB (Risk appetite and tolerance: guidance for practitioners, <https://www.theirm.org>) that for clarity and simplicity, uses only the terms **risk appetite** and **risk limits**. Risk limits are the limits of the risk appetite.

## 2. Risk Appetite Framework

The RAF sets **the financial institution's risk profile** and **forms part of the process of development and implementation of the institution's strategy** and determination of the risks undertaken in relation to the institution's risk capacity.

For the FSB, **an effective RAF should:**

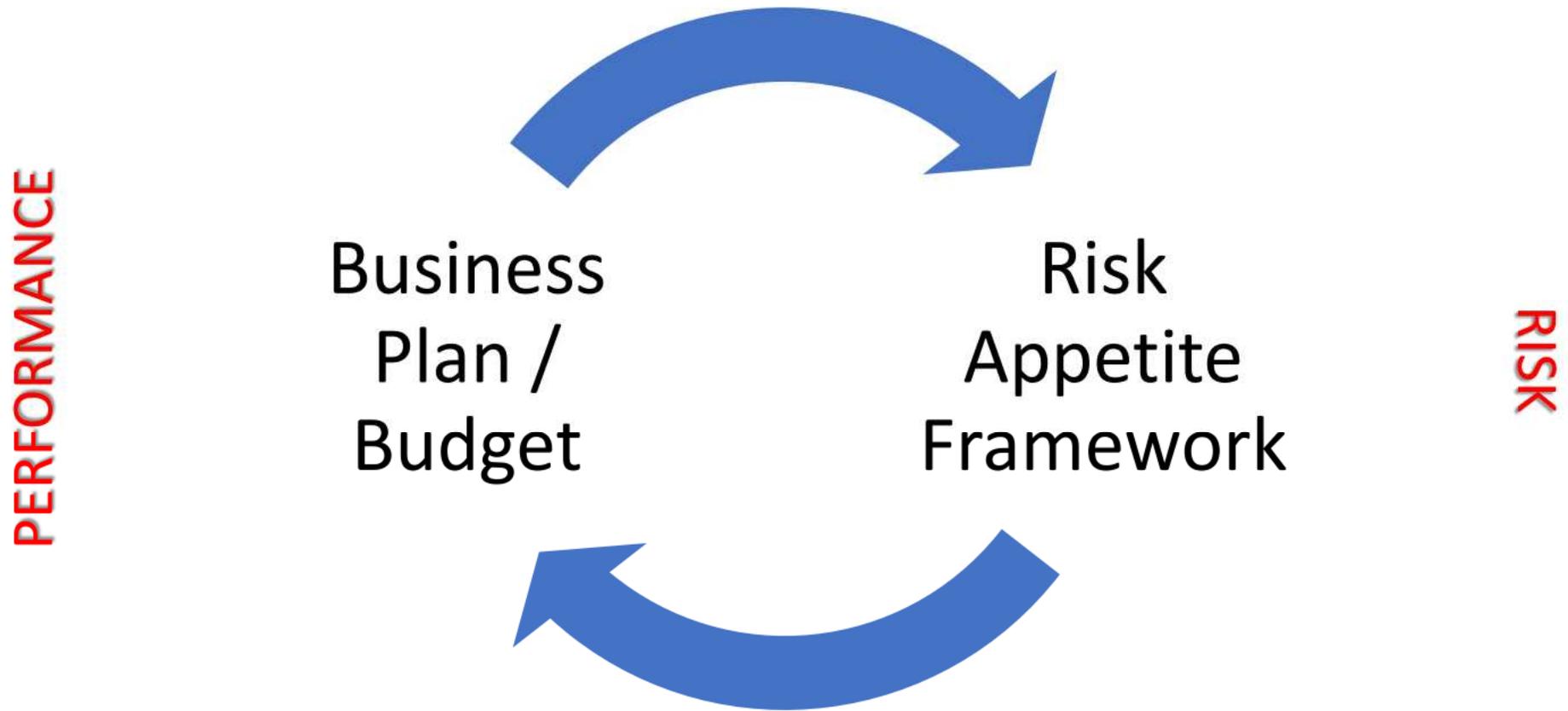
- a) establish a process for **communicating the RAF across and within** the financial institution as well as sharing non-confidential information to external stakeholders (shareholders, depositors etc.);
- b) be driven by both **top-down** board leadership **and bottom-up** involvement of management at all levels, and embedded and understood across the financial institution;
- c) facilitate **embedding risk appetite** into the financial institution's risk culture;
- d) evaluate **opportunities for appropriate risk taking** and act as a defense against excessive risk-taking;
- e) allow for the risk appetite statement to be used as **a tool to promote robust discussions on risk** and as a basis upon which the board, risk management and internal audit functions can effectively and credibly debate and challenge management recommendations and decisions;
- f) be **adaptable** to changing business and market conditions so that, subject to approval by senior management and the board as appropriate, opportunities that require an increase in the risk limit of a business line or legal entity could be met while remaining within the agreed institution-wide risk appetite
- g) cover activities, operations and systems of the financial institution that fall within its risk landscape **but** are outside its direct control, including subsidiaries and third party outsourcing suppliers; and
- h) be **consistent** with the principles in the document.

### 3. Risk Appetite Statement

For the FSB, **an effective RAS should:**

- a) include key **background** information and assumptions that informed the financial institution's strategic and business plans at the time they were approved;
- b) be linked to the institution's short- and long-term **strategic, capital and financial plans**, as well as compensation programs;
- c) establish the amount of risk the financial institution is prepared to accept in pursuit of its **strategic objectives** and **business plan**, taking into account the interests of its customers (e.g. depositors, policyholders) and the fiduciary duty to shareholders, as well as capital and other regulatory requirements;
- d) determine **for each material risk and overall the maximum level of risk** that the financial institution is willing to operate within, based on its overall risk appetite, risk capacity, and risk profile;
- e) include **quantitative measures** that can be translated into risk limits applicable to business lines and legal entities as relevant, and at group level, which in turn can be aggregated and disaggregated to enable measurement of the risk profile against risk appetite and risk capacity;
- f) include **qualitative statements** that articulate clearly the motivations for taking on or avoiding certain types of risk, including for reputational and other conduct risks across retail and wholesale markets, and establish some form of boundaries or indicators (e.g. non-quantitative measures) to enable monitoring of these risks;
- g) ensure that the strategy and risk limits of **each business line and legal entity**, as relevant, align with the institution-wide risk appetite statement as appropriate; and
- h) be **forward looking** and, where applicable, subject to scenario and stress testing to ensure that the financial institution understands what events might push the financial institution outside its risk appetite and/or risk capacity.

### 3. Risk Appetite Statement



## 4. Risk Limits

For the FSB, **Risk limits should:**

- a) be set at a **level to constrain** risk-taking within risk appetite, taking into account the interests of customers (e.g. depositors, policyholders) and shareholders as well as capital and other regulatory requirements, in the event that a risk limit is breached and the likelihood that each material risk is realized;
- b) be established for business lines and legal entities as relevant and generally expressed relative to **earnings, capital, liquidity or other relevant measures** (e.g. growth, volatility);
- c) include **material risk concentrations** at the institution or group-wide, business line and legal entity levels as relevant (e.g. counterparty, industry, country/region, collateral type, product);
- d) although referenced to market best practices and benchmarks, should **not be strictly based on comparison** to peers or default to regulatory limits;
- e) **not** be overly **complicated, ambiguous, or subjective**; and
- f) be **monitored** regularly.

## 5.1. Risk Appetite – How to make it work?

“**First: what is a risk appetite framework?** Well, **the term captures the overall approach banks take when establishing their risk appetite.** This includes policies, processes, limits, controls and systems put in place by banks to **define, communicate** and **monitor** how much risk they are willing to take on”.

“The second question is: **how to judge the quality of risk appetite frameworks?** As supervisors, we have **four things in mind when doing so:** they should be

1. comprehensive,
2. effectively governed,
3. consistently used, and
4. fully integrated into strategic decision-making”.

“The idea of a risk appetite framework is to help the bank define its appetite for risk. And this needs to be articulated and put down in writing. In their **risk appetite statements**, banks should spell out how much risk, and of what kind, they are willing to take on. These statements are crucial to ensure consistent risk management throughout the bank. They also allow the board to have a holistic view of the risks that need to be managed.”

Speech by **Danièle Nouy**, Chair of the Supervisory Board of the ECB, International Conference on Banks' Risk Appetite Frameworks, Ljubljana, 10 April 2018

## 5.2. Risk Appetite – Where do we stand?

We see that risk appetite frameworks are, on the whole, something new for banks. In 2015, around 30% of banks' risk appetite frameworks were less than two years old. Another 12% were still being developed. All in all, risk appetite frameworks differ widely across banks.

At the same time, banks have made **progress**. Their risk appetite frameworks are now **better structured and subject to clearer governance**. For instance, most banks have clarified the role of the relevant stakeholders involved in the risk appetite framework. On top of that, in many banks, internal auditors have reviewed the effectiveness of risk appetite frameworks.

Another thing to mention is that many of these frameworks cover **a broader set of risks** than before. And this leads to a fundamental question: how to measure risk in the first place? But don't worry; I am not going to explore the ins and outs of risk theory. Let me just say this: most banks now use a broader set of metrics to measure risks. Most banks go beyond the regulatory minimum to define metrics which are more suited to their business models.

Now, once a bank has defined its risk appetite, it must align its risk profile. To facilitate this task, most banks now use what we call **risk appetite dashboards**. These dashboards compare actual risk exposures and risk limits to the risk appetite. This is **helpful for discussions** among senior management and within the board.

Speech by **Danièle Nouy**, Chair of the Supervisory Board of the ECB, International Conference on Banks' Risk Appetite Frameworks, Ljubljana, 10 April 2018

### 5.3. Risk Appetite – What do banks need to work on?

**Despite this progress, banks need to improve in some respects.** If they don't, their risk appetite frameworks will not be as effective as they could be. So let me highlight four things that banks need to work on.

1. **Risk appetite frameworks do indeed cover more risks than before but still not enough. Non-financial risks** are often insufficiently covered or even completely left out, for instance. And this leads to a long list topped by risks such as **compliance** and **reputational risks, IT risks, legal risks** and **conduct risks**. If the bank cannot put concrete numbers to these risks, it should at least use qualitative statements. In this context, we appreciate the fact that **some banks are working on relevant quantitative and objective indicators**.

2. **The governance of risk appetite frameworks must be further improved.** Boards need to play a bigger role in the definition and review of risk appetite frameworks. The same is true for banks' risk function. Many banks must enhance the role this function plays, in particular when it comes to defining and approving limits.

Speech by **Danièle Nouy**, Chair of the Supervisory Board of the ECB, International Conference on Banks' Risk Appetite Frameworks, Ljubljana, 10 April 2018

### 5.3. Risk Appetite – What do banks need to work on?

3. Risk appetite limits: These **limits need to be set and used in a comprehensive manner**. Banks need to break these limits down to business lines – and some banks don't do that. Banks also need to break the limits down to entities and countries. And where this is done, the local limits are sometimes not consistent with the limits at consolidated level. This is something banks need to work on. They also need to work on how they calculate and actually apply limits. What we often see is that risk limits are in place but they do not sufficiently constrain risk-taking. The reason is that the limits are often set so high that there's virtually no possibility of breaching them. This calls into question the entire risk appetite framework. We expect banks to use risk appetite limits as a tool to monitor their risk profiles, keep risks in check and set the right incentives for the whole of the organization. If the limits are set too high, they cannot achieve these objectives. In this context, some banks have defined early warning signals, enabling them to detect deteriorations in the bank's risk profile even before risk limits are actually breached.

4. How banks **embed risk appetite frameworks in their strategic processes**. Over the past three years, we have closely studied these issues. And we have realized in particular that the effectiveness of risk appetite frameworks does not depend on a bank's business model, its size or the country it operates in. It means that banks need to take a holistic approach to risk culture and risk management, including risk appetite. These things need to be perfectly attuned. And they need to be in harmony with the rest of the organization – with the business model and with remuneration schemes, among other things.

Speech by **Danièle Nouy**, Chair of the Supervisory Board of the ECB, International Conference on Banks' Risk Appetite Frameworks, Ljubljana, 10 April 2018

## 5.4. Risk Appetite – Conclusions

Too many banks still wrongly see their risk appetite framework as **a separate tool, unrelated to decision-making**. This framework needs to be an integral part of the decision-making process. Also, most banks do not use risk appetite limits and statements as **tools to facilitate discussion at various levels of the organization**.

They need to change this approach. And more generally, they need to create better incentives for complying with risk appetite frameworks.

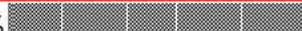
**Risk is at the heart of banking.** Banks need to find ways to deal with it. It seems however that, prior to the crisis, some banks were too busy taking on risks to be able to properly manage them. As a consequence, they took on more risks than they could cope with.

Risk appetite frameworks play a **key role** here; we take them seriously and so should the banks. After all, the frameworks help banks to define the level of risk they are willing to take on. This in turn helps them to keep their risks under control and manage them properly. My impression is that many banks have made good progress. However, there is still room for improvement. It's in the banks' own interest.

Speech by **Danièle Nouy**, Chair of the Supervisory Board of the ECB, International Conference on Banks' Risk Appetite Frameworks, Ljubljana, 10 April 2018

## 6. Case study

### RISK APPETITE STATEMENT AND RISK APPETITE FRAMEWORK OF A BANKING GROUP

Risk Appetite Framework	Risk Appetite Statement Indicator	Risk Appetite	Risk Tolerance	Risk Capacity
Capital Adequacy & Leverage	Common Equity Tier 1 Ratio ("CET 1 Ratio")	11.60%	10.50%	8.50%
	Total Capital Ratio ("TC Ratio")	12.70%	12.00%	9.50%
	MAX RWA - Market Risk	< 4.00%	7.00%	
	Leverage ratio	≥ 3.00%	2.60%	2.50%
Liquidity Adequacy	Liquidity Coverage Ratio ("LCR")	≥ 110.00%	100.00%	80.00%
	Net Stable Funding Ratio ("NSFR")	≥ 100.00%	80.00%	70.00%
	Survival Period	> 90gg	30gg	
Credit Quality	(Net Unlikely to pay + Net Bad exposures)/CET1	≤ 80.00%	100.00%	
	Growth rate of gross Non Performing Loans	-2.00%	0.00%	28.00%
	Net losses on impairment/Non Performing Loans	42.00%	39.00%	27.00%
Interest rate of banking book	Variation of the Net Economic Value/Total Capital		15.00%	20.00%
Market	Max exposure Sovereign Italy between AfS		8 billions	
Business sustainability	Net operating profit (NOP/RWA)	> 0.40%	0.30%	0.00%
Compliance	Minimum level of opinion on report	Partially satisfactory	Partially unsatisfactory	

**FOCUS** ←

In the following slides we will focus on the Credit Quality Risk, a good example of quantitative measures, and on the Compliance Risk, a good example of a qualitative measures.

## 6. Case study

### RISK APPETITE STATEMENT OF A BANKING GROUP – Credit Quality

Credit Quality_1	
(Net unlikely to pay + net bad exposures) / CET 1	
<b>Method</b>	Ratio between loans and receivable with customers classified as Net unlikely to pay or bad exposures and the CET 1. The gross exposures are netted of the total impairment.
<b>Risk Appetite</b>	≤ 80%
<b>Risk Tolerance</b>	100%
<b>Risk Capacity</b>	n.a.
<b>Monitoring Period</b>	Quarterly monitored. Risk profile at every monitoring period → 90% The Risk appetite has an horizon of 1 year.
<b>Countermeasures</b>	<ul style="list-style-type: none"> <li>- Sale of the NPL</li> <li>- Cartolarization of the NPL portfolio</li> <li>- Issuing of instruments to raise the CET 1</li> </ul> The preferred countermeasures will be choose case-by-case

## 6. Case study

### RISK APPETITE STATEMENT OF A BANKING GROUP – Credit Quality

#### Credit Quality\_2

#### Growth rate of Non Performing Loans (NPL)

<b>Method</b>	Ratio between the difference between the stock of loans and receivables with customers classified as NPL at t(0) less the stock of loans and receivables with customers classified as NPL at t(1) and the stock of loans and receivables with customers classified as NPL at t(0)
<b>Risk Appetite</b>	- 2%
<b>Risk Tolerance</b>	0%
<b>Risk Capacity</b>	+28%
<b>Monitoring Period</b>	Quarterly monitored. Risk tolerance at every monitoring period (calculated with respect to the previous quarter) → 0% The Risk appetite has an horizon of 1 year.
<b>Countermeasures</b>	<ul style="list-style-type: none"> <li>- Sale of the NPL</li> <li>- Cartolarization of the NPL portfolio</li> </ul> The preferred countermeasures will be choose case-by-case

## 6. Case study

### RISK APPETITE STATEMENT OF A BANKING GROUP – Credit Quality

#### Credit Quality\_3

#### Net losses on impairment of loans/Non Performing Loans

<b>Method</b>	Ratio between the impairment of loans and the total stock of NPL
<b>Risk Appetite</b>	42%
<b>Risk Tolerance</b>	39%
<b>Risk Capacity</b>	27%
<b>Monitoring Period</b>	Quarterly monitored. Risk tolerance at every monitoring period (calculated with respect to the previous quarter) → equal to the Risk Profile of the previous monitoring period The Risk appetite has an horizon of 1 year.
<b>Countermeasures</b>	<ul style="list-style-type: none"> <li>- Sale of the NPL</li> <li>- Cartolarization of the NPL portfolio</li> </ul> The preferred countermeasures will be choose case-by-case

## 6. Case study

### RISK APPETITE STATEMENT OF A BANKING GROUP – Compliance

#### Compliance\_1

#### Minimum Level of opinion on report

<b>Method</b>	The level is assessed on every report drawn up
<b>Risk Appetite</b>	Partially satisfactory
<b>Risk Tolerance</b>	Partially unsatisfactory
<b>Risk Capacity</b>	n.a.
<b>Monitoring Period</b>	Monitoring is based on Compliance Report on the procedure and policy of the group, in which the compliance officer gives an opinion.
<b>Countermeasures</b>	Countermeasures are designed and taken in a case-by-case basis.

## 6. Case study

### Results of the monitoring activities in the first quarter 2017

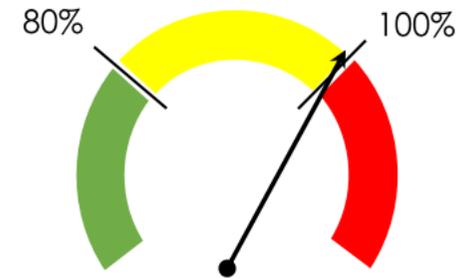
<i>Risk Appetite Framework</i>	<i>Risk Appetite Statement Indicator</i>	<i>Risk Appetite</i>	<i>Risk Tolerance</i>	<i>Risk Capacity</i>	<i>Risk Profile</i>
Capital Adequacy & Leverage	Common Equity Tier 1 Ratio ("CET 1 Ratio")	11.60%	10.50%	8.50%	10.60%
	Total Capital Ratio ("TC Ratio")	12.70%	12.00%	9.50%	12.00%
	MAX RWA - Market Risk	< 4.00%	7.00%		5.00%
	Leverage ratio	≥ 3.00%	2.60%	2.50%	2.70%
Liquidity Adequacy	Liquidity Coverage Ratio ("LCR")	≥ 110.00%	100.00%	80.00%	105.00%
	Net Stable Funding Ratio ("NSFR")	≥ 100.00%	80.00%	70.00%	90.00%
	Survival Period	> 90gg	30gg		40gg
Credit Quality	(Net Unlikely to pay + Net Bad exposures)/CET1	≤ 80.00%	100.00%		100.00%
	Growth rate of gross Non Performing Loans	-2.00%	0.00%	28.00%	3.00%
	Net losses on impairment/Non Performing Loans	42.00%	39.00%	27.00%	40%
Interest rate of banking book	Variation of the Net Economic Value/Total Capital		15.00%	20.00%	14.00%
Market	Max exposure Sovereign Italy between AFS		8 billions		7 billions
Business sustainability	Net operating profit (NOP/RWA)	> 0.40%	0.30%	0.00%	0.34%
Compliance	Minimum level of opinion on report	Partially satisfactory	Partially unsatisfactory		(3/3)

The results of the monitoring activities have enlightened that all the limits were respected, with the exception of the Total Capital Ratio, and two ratio of the Credit quality. The BoD decides to take actions against the credit quality risk.

## 6. Case study

### Results of the monitoring activities in the first quarter 2017

(Net Unlikely to pay + Net Bad exposures)/CET1

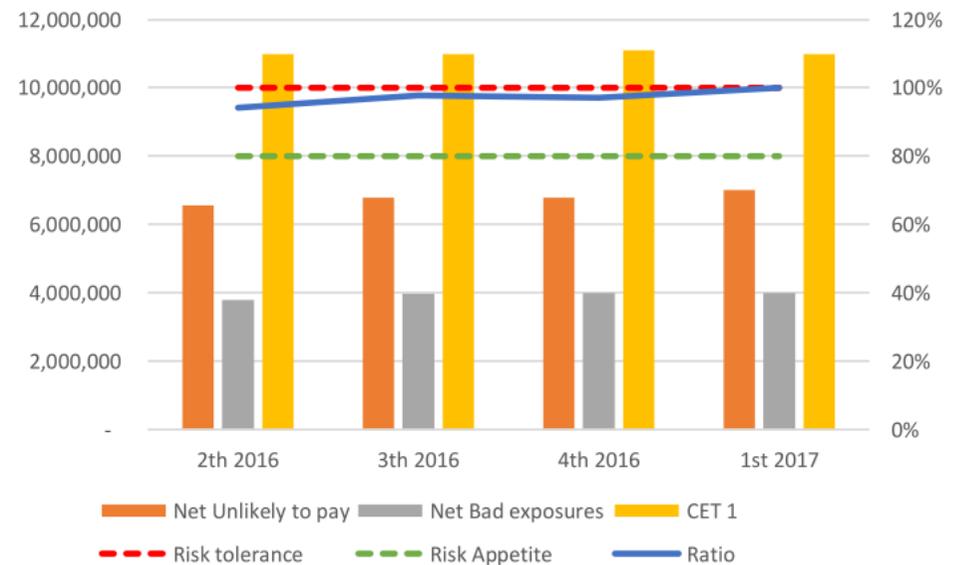


	2th 2016	3th 2016	4th 2016	1st 2017
Net Unlikely to pay	6,555,000	6,770,000	6,790,000	7,000,000
Net Bad exposures	3,800,000	3,980,000	4,000,000	4,000,000
CET 1	11,000,000	11,000,000	11,120,000	11,000,000
Ratio	94%	98%	97%	100%

**!** Increase of the Net Unlikely to pay

### Possible Countermeasures:

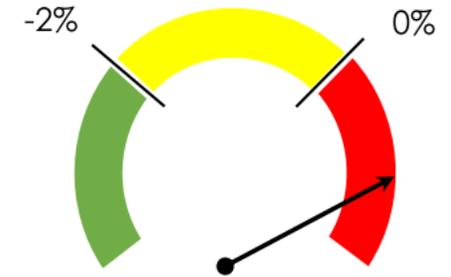
1. Sale of the NPL
2. Cartolarization of the NPL portfolio
3. Issuing of instruments to raise the CET 1



## 6. Case study

### Results of the monitoring activities in the first quarter 2017

#### Growth rate of Non Performing Loans



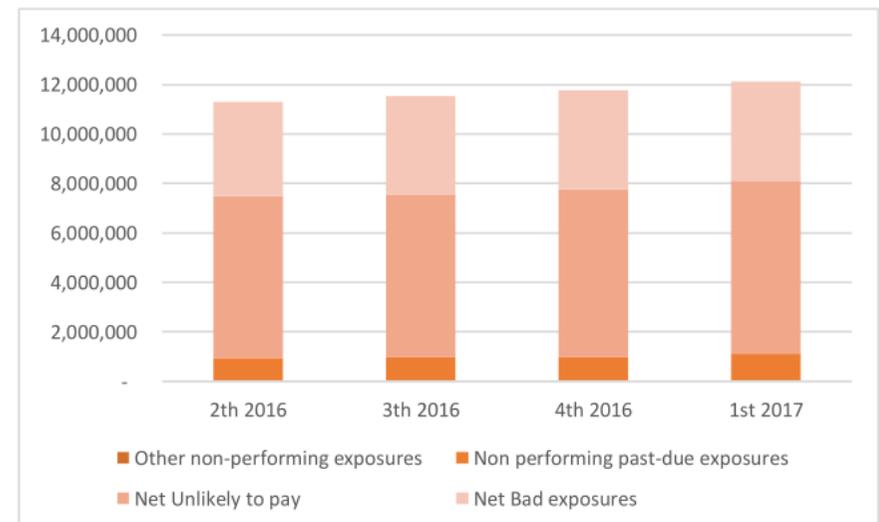
! Increase of the Net Unlikely to pay

! Increase of the Non Performing past-due

#### Possible Countermeasures:

1. Sale of the NPL
2. Cartolarization of the NPL portfolio
3. Issuing of instruments to raise the CET 1

<i>Euro/000</i>	<b>2nd 2016</b>	<b>3rd 2016</b>	<b>4th 2016</b>	<b>1st 2017</b>
Other non-performing exposures	20,000	23,000	19,000	25,000
Non performing past-due	920,000	940,000	950,000	1,090,000
Net Unlikely to pay	6,555,000	6,600,000	6,790,000	7,000,000
Net Bad exposures	3,800,000	3,980,000	4,000,000	4,000,000
<b>Totale</b>	<b>11,295,000</b>	<b>11,543,000</b>	<b>11,759,000</b>	<b>12,115,000</b>
<b>Ratio</b>		<b>2.2%</b>	<b>1.9%</b>	<b>3.0%</b>

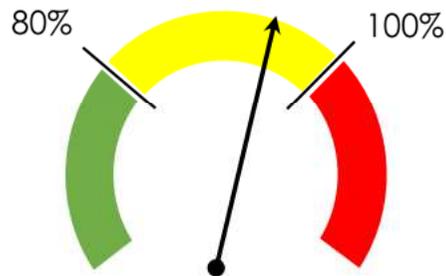


## 6. Case study

### Countermeasures

The BoD decides to sell a part of the NPL portfolio. A counterparty buys Unlikely to pay loans for 450 Euro/M of net book value, at a price of 400 Euro/M. Below the effects on the ratios:

(Net Unlikely to pay + Net Bad exposures)/CET1



Euro/000	2nd 2016	3rd 2016	4th 2016	1st 2017	2nd 2017
Net Unlikely to pay	6,555,000	6,770,000	6,790,000	7,000,000	6,550,000
Net Bad exposures	3,800,000	3,980,000	4,000,000	4,000,000	4,100,000
CET 1	11,000,000	11,000,000	11,120,000	11,000,000	11,000,000
Risk tolerance	100%	100%	100%	100%	100%
Risk Appetite	80%	80%	80%	80%	80%
Ratio	94%	98%	97%	100%	97%

Growth rate of Non performing loans (%)



Euro/000	2nd 2016	3rd 2016	4th 2016	1st 2017	2nd 2017
Other non-performing exposures	20,000	23,000	19,000	25,000	25,000
Non performing past-due	920,000	940,000	950,000	1,090,000	1,200,000
Net Unlikely to pay	6,555,000	6,600,000	6,790,000	7,000,000	6,550,000
Net Bad exposures	3,800,000	3,980,000	4,000,000	4,000,000	4,100,000
Totale	11,295,000	11,543,000	11,759,000	12,115,000	11,875,000

Ratio	2.2%	1.9%	3.0%	-2.0%
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