



TOPICS:

Geopolitical risk

SOURCE:

Bank of Italy

Bankit: Geopolitical Risk, Banks' Exposure and Supervisory Assessment Framework

- This paper examines how **geopolitical uncertainty (GPU)** should be **incorporated into banking supervision**, particularly for Italian Less Significant Institutions (LSIs). Its central proposition is that **geopolitical developments should not constitute a standalone prudential risk category**.
- Instead, wars, sanctions, trade fragmentation, cyber conflict and political instability operate as **cross-cutting drivers that amplify conventional banking risks**, including credit, market, liquidity, funding, operational and governance risks.
- The paper distinguishes geopolitical "risk" from **fundamental uncertainty**. Because geopolitical events involve strategic interactions, regime shifts and limited historical evidence, **their probabilities cannot reliably be inferred from stable distributions**. Consequently, conventional quantitative measurement should be supplemented by **scenario analysis, stress testing, expert judgment, forward-looking provisioning and robustness assessments**.
- A key supervisory distinction concerns transmission channels. **Significant Institutions (SIs) generally face more direct exposure** through cross-border activities, securities portfolios, market repricing and wholesale funding.

LSIs are typically affected more **indirectly** through domestic borrowers, sectoral and geographic concentrations, deposit behaviour and dependencies on ICT, cloud and other third-party providers. Thus, **limited direct international exposure does not imply limited geopolitical vulnerability**.

- Banca d'Italia's supervisory approach **embeds geopolitical effects within existing supervisory processes**, including **SREP, ICAAP/ILAAP, provisioning assessments, governance, funding sustainability and operational resilience**. Capital demand remained primarily driven by traditional prudential channels, particularly credit, concentration and interest-rate risks, through which geopolitical pressures may ultimately materialise.
- Finally, the paper proposes an adapted **Merton-style structural framework** linking geopolitical stress to asset returns and volatility, correlations, funding costs, liability run-offs, payouts, distance-to-default and default probabilities. **Its purpose is not precise forecasting or the introduction of a dedicated geopolitical capital charge**, but to provide a structured tool for **forward-looking supervisory scenario analysis**, while preserving institution-specific supervisory judgment.