FSB FINANCIAL STABILITY BOARD

Increasing the Intensity and Effectiveness of Supervision

Consultative Document

Guidance on Supervisory Interaction with Financial Institutions on Risk Culture

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Background

Increasing the intensity and effectiveness of supervision is a key component of the Financial Stability Board's (FSB's) efforts to reduce the moral hazard of systemically important financial institutions (the SIFI Framework), along with requiring added capital loss absorbency and facilitating the orderly resolution of financial institutions.[1] The FSB issued its first recommendations for enhanced supervision of financial institutions, in particular SIFIs, in October 2010, which underscored the key preconditions for effective supervision, including the need for (i) strong and unambiguous mandates; (ii) independence to act; (iii) sufficient quality and quantity of resources; and (iv) supervisors having a full suite of powers to execute on their mandate. Subsequent recommendations in 2011 and 2012 strengthened the supervisory expectations for financial institutions' risk governance and internal controls, risk management functions, as well as risk aggregation and risk reporting capabilities.[2] A number of these recommendations have been implemented and, collectively, have raised the bar for both supervisors and SIFIs.

This paper takes forward the recommendation set out in the November 2012 progress report *Increasing the Intensity and Effectiveness of SIFI Supervision* for supervisors to explore ways to formally assess risk culture at financial institutions, particularly at SIFIs. The paper draws on the collective experience and efforts of supervisory and regulatory authorities across the FSB membership and insights garnered from market participants through roundtables and bilateral discussions.[3]

The FSB invites comments on the draft guidance by 31 January 2014. Responses should be sent to fsb@bis.org. Responses will be published on the FSB's website unless respondents expressly request otherwise.

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1 http://www.financialstabilityboard.org/publications/r_101111a.pdf.

2 See *Intensity and Effectiveness of SIFI Supervision*, FSB, November 2010, November 2011, November 2012. The expectation is that firms should have 'strong' and not merely 'good' risk management, and that high standards of risk management should be fully integrated into a firm's culture and compensation practices.

3 The FSB Supervisory Intensity and Effectiveness (SIE) group held a roundtable on risk appetite, which included discussion on risk culture, with risk committee chairs and chief risk officers of banks and insurers and had discussions with the Group of Thirty, KPMG, and McKinsey & Company on their respective work in this area. In addition, members of the SIE participated in the July 2013 IIF Symposium on Supervision which focused on risk culture at financial institutions.

Introduction

Increasing the intensity and effectiveness of supervision is a key pillar of the Financial Stability Board's (FSB's) efforts to reduce the risks posed by systemically important financial institutions (SIFIs). A more intense and effective approach to oversight aims to deliver pre-emptive, rather than reactive, outcomes-based supervision. Outcomes-based supervision involves proactively assessing the decisions of the financial institution based on its strategic vision, business model and risk appetite framework; supervision is not only about ensuring compliance with the rules but also with the spirit. At the crux of this supervisory approach is an understanding, by both the financial institution and the supervisor of the institution's risk culture[4], in particular whether it supports appropriate behaviours and judgements within a strong risk governance framework. In order to achieve this outcome, supervisory interaction with boards should be stepped up, in terms of frequency and level of seniority. An anticipatory and strategic approach to supervision rests, among other things, on the ability to engage in high-level sceptical conversations with the board and senior management on the financial institution's risk appetite framework, and whether the institution's risk culture supports adherence to the agreed risk appetite.

Failures in risk culture are often considered a root cause of the global financial crisis as well as headline risk and compliance events (e.g. the London whale, LIBOR manipulation). A financial institution's risk culture plays an important role in influencing the actions and decisions taken by individuals within the institution and in shaping the institution's attitude toward its stakeholders, including its supervisors. A risk culture that promotes prudent risk-taking and discourages unrestrained profit maximisation without due regard to risks supports an environment that is conducive to ensuring that emerging risks that will have a material impact on a financial institution, and any risk-taking activities beyond the institution's risk appetite, are recognised, assessed, escalated, and addressed in a timely manner. Weaknesses in the risk management framework, as well as in decision-making processes and in assigning clear accountability for identifying and addressing behaviours not supportive of sound risk management, enable particular risks to take root and grow.

This paper identifies the foundational elements that contribute to the promotion of a sound risk culture within a financial institution (see Section 1). It aims to assist supervisors in identifying those core practices and attitudes that may be indicators of the institution's risk culture (see Section 2).[5] Differences in risk culture might be driven in part by differences in corporate and also national cultures.[6] Therefore, the paper does not define a "good" or "bad" culture but provides guidance for supervisors to assess the strength and effectiveness of a financial institution's culture in managing

[4] The 2009 International Institute of Finance report "*Reform in the financial services industry: Strengthening Practices for a More Stable System* defines risk culture as the norms of behaviour for individuals and groups within an organisation that determine the collective ability to identify and understand, openly discuss and act on the organisations current and future risk.

[5] This paper will evolve as more experience is gained and additional insights are garnered.

[6] Although the guidance focuses on the specific role played by risk culture and how to assess a financial institution's risk culture, it is recognised that risk culture is embedded in the institution's overall corporate culture. The latter evolves over time, in relation to the events that affect the institution's history (such as mergers and acquisitions) and to the external context within which the institution operates.

risks (see Section 3). Supervisors should satisfy themselves that risk cultures are based on sound, articulated values and are carefully managed by the leadership of the financial institution.

1. Foundational elements of a sound risk culture

Risk cultures vary across financial institutions, and sub-cultures may exist within institutions, but there are certain foundational elements that contribute to (but do not determine) promotion of a sound risk culture within the institution, such as effective risk governance and risk appetite frameworks and compensation practices that promote appropriate risk-taking behaviour. These important foundational elements have been further elaborated by the FSB, and financial institutions, in particular SIFIs, are expected to meet supervisory expectations set out in the following papers:

Risk Governance

The FSB *Thematic Review on Risk Governance*[7] set out sound practices for effective risk governance, including the roles and responsibilities of the board, the chief risk officer and risk management function, and the independent assessment of the risk governance framework. The report sets out an integrated and coherent list of sound practices that establish supervisory expectations for the role and responsibilities of the board as well as the stature, resources, authority and independence of the risk management and internal audit functions. Governance processes should be designed to work against the erosion of risk management practices through changing business and economic environments.

Risk Appetite

The FSB has issued for consultation *Principles for an Effective Risk Appetite Framework*[8]. The 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 in establishing the approved risk appetite statement. Embedded in these Principles is the assumption that financial institutions have the processes to establish their strategy and develop their business plan, and the models and systems to measure and aggregate risks. A sound risk culture is a substantial determinant of whether an institution is able to successfully execute its agreed strategy within its defined risk appetite.

Compensation

The FSB *Principles*[9] and *Standards for Compensation Practices*[10] aim to ensure effective governance of compensation, alignment of compensation with prudent risk taking and effective supervisory oversight and stakeholder engagement in compensation. An employee's compensation should take account of the risks that the employee takes on behalf of the financial institution and the

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7 See http://www.financialstabilityboard.org/publications/r_130212.pdf.

8 See http://www.financialstabilityboard.org/publications/r_130717.pdf.

9 See http://www.financialstabilityboard.org/publications/r_0904b.pdf.

10 See http://www.financialstabilityboard.org/publications/r_090925c.pdf.

employee's performance in meeting the institution's risk, compliance, and other important policies. Compensation should take into consideration prospective risks as well as risk outcomes that are already realised.

2. Indicators of a sound risk culture

There are several indicators of a sound risk culture that need to be considered collectively and as mutually reinforcing; looking at each indicator in isolation will ignore the multi-faceted nature of risk culture. These indicators include:

- *Tone from the top*: The board of directors[11] and senior management are the starting point for setting the financial institution's core values and risk culture, and their behaviour must reflect the values being espoused. As such, the leadership of the institution should systematically develop, monitor, and assess the culture of the financial institution.
- *Accountability:* Successful risk management requires employees at all levels to understand the core values of the institutions' risk culture and its approach to risk, be capable of performing their prescribed roles, and be aware that they are held accountable for their actions in relation to the institution's risk-taking behaviour. Staff acceptance of risk-related goals and related values is essential.
- *Effective challenge*: A sound risk culture promotes an environment of effective challenge in which decision-making processes promote a range of views, allow for testing of current practices, and stimulate a positive, critical attitude among employees and an environment of open and constructive engagement.
- *Incentives*: Performance and talent management should encourage and reinforce maintenance of the financial institution's desired risk management behaviour. Financial and non-financial incentives should support the core values and risk culture at all levels of the financial institution.

The following sets out some general guidance to assist supervisors in analysing these common elements as they conduct their ongoing supervisory work which may provide insight into the strength and effectiveness of a financial institution's culture in managing risk.

3. General supervisory guidance

Supervisors are in a unique position to assess risk culture at financial institutions given their access to information and individuals across the institution, as well as the results of supervisory work. Supervisors should not view an assessment of risk culture as a point in time review, but as part of

[11] The term board refers to the oversight function and the management function in general and should be interpreted throughout the document in accordance with the applicable law within each jurisdiction. The same applies to the committees mentioned in this report which may be under the control of different board functions, accordingly, subject to the board structure and subject to the respective tasks. Recognising that different structural approaches to corporate governance exist across countries, this document encourages practices that can strengthen checks and balances and sound risk governance under diverse structures.

the ongoing assessment of the firm. Assessing risk culture is embedded in every supervisory activity, and this requires supervisors to develop broad-based experience and as well as the appropriate skill set needed for an effective, senior level interaction with firms on the role played by risk culture. Assessing risk culture entails identifying the root cause of *why* there are supervisory findings – not just *what* the findings are. It includes identifying practices, behaviours or attitudes that are not supportive of sound risk management and intervening early to address these culture observations and thereby potential excess build-up of risk. The underlying causes of these findings should be embedded in supervisory reports and discussed with the board and senior management.

Since the global financial crisis, supervisory approaches are increasingly becoming more direct and more intense to promote the resilience of the financial system. The challenge for supervisors is to strike the right balance between taking a more intensive, proactive approach and not unduly influencing strategic decisions of financial institution's management. Risk culture is an area where a growing number of supervisory authorities are taking a more active role, and the range of supervisory approaches toward assessing risk culture varies.[12] While supervisors have traditionally formed a view on a financial institution's attitude toward and acceptance of risk, these views have not necessarily been communicated formally (or informally) to the board and senior management in regard to how certain behaviours are hindering effective and sound risk management.

Supervisors should constantly assess risk culture indicators and the processes in place by which the institution's leadership ensures that its core values are communicated, understood, embraced and monitored throughout the organisation. Evidence should be gathered from the full range of supervisory activities so as to avoid being perceived and managed as a compliance-driven exercise. Identification of a practice or attitude that is not supportive of sound risk management should be brought to the attention of the board and senior management to influence change in a positive direction. In particular, behaviours that underpin supervisory findings should be highlighted to the board, which has ultimate responsibility for the financial institution's risk culture. The supervisor raising, and the financial institution acting early to address, the root causes of the behavioural weakness will aid in preventing (or mitigating the impact of) particular cultural norms from taking root and growing. In particular, supervisors should assess how the board and senior management systematically assess the risk culture of the institution, and document what they are finding and how any deficiencies in risk culture are addressed. The institution's willingness to sufficiently document the elements supporting its risk culture should form part of the supervisor's overall assessment.[13] Supervisors should also seek supporting evidence regarding how a firm systematically assesses risk culture including the processes used (e.g. employee surveys, independent reviews, internal reporting) and action plans to address findings on matters that may come to their attention. This evidence may be further supported by discussions the supervisory authority may conduct with members of the board and senior management.

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[12] Some authorities have been consulting or hiring behavioural psychologists while others have conducted horizontal reviews on an institution's decision-making process or reputational risk management.

[13] In the case of multiple documents, it will be important for supervisors to examine whether a joint reading of the different documents produces a coherent picture of the institution's desired risk culture.

3.1 Tone from the top

The board of directors and senior management are the starting point for setting a financial institution's risk culture and promoting appropriate risk-taking behaviours. The attitudes communicated by the board and senior management are critical as over time, their behaviour in demonstrating adherence to sound risk management will be emulated by the rest of the institution. Non-executive directors can play an important role in bringing experience from other industries where behaviours and practices generally necessitate a sound risk culture (e.g., healthcare, nuclear energy) and often are well placed to bring a fresh perspective and sage advice about issues such as behaviours in relation to overall culture. It is the overarching responsibility of the board and senior management to set the tone at the top, including by clearly articulating the underlying values that support the desired risk culture and behaviours; recognising, promoting and rewarding behaviour that reflects the stated risk culture and its core values; and systematically monitoring and assessing the actual culture. The board and senior management should proactively address behavioural issues and assess whether they are clearly and effectively articulating and monitoring the core values and expected behaviours toward risk. The appropriate tone and standard of behaviour 'at the top' is a necessary condition for promoting sound risk management. However, it is far from sufficient. For lasting change, the tone and behaviour 'in the middle', and indeed throughout the institution, is also important.

Indicators of tone from the top

Leading by example

3.1.1 The board and senior management are committed to establishing, monitoring, and adhering to an effective risk appetite statement that underpins the financial institution's risk management strategy and is integrated with the overall business strategy.

3.1.2 The board and senior management have a clear view of the risk culture to which they aspire for the financial institution, systematically monitor and assess the prevailing risk culture and proactively address any identified areas of weakness or concern.

3.1.3 The board and senior management promote through actions and words a risk culture that expects integrity and a sound approach to risk.

3.1.4 The board and senior management promote an open exchange of views, challenge and debate, including ensuring that all directors have the tools, resources and information to carry out their roles effectively, particularly their challenge function.

3.1.5 The board and senior management have mechanisms in place, such as talent development and succession planning, which help to lessen the influence of dominant personalities and behaviours.

Assessing espoused values

3.1.6 The board and senior management systematically assesses whether the espoused values are communicated and adhered to by management and staff at all levels to ensure that the 'tone at the middle' and throughout the institution as a whole is the same as the 'tone at the top'.

3.1.7 The board and senior management have mechanisms in place to assess whether the risk appetite statement, risk management strategy and overall business strategy are clearly understood and embraced by management and staff at all levels, and effectively embedded in the decision-making and operations of the business.

3.1.8 The board and senior management have established a compensation structure that supports the institution's espoused core values and promotes prudent risk-taking behaviour.

Ensuring common understanding and awareness of risk

3.1.9 The board and senior management demonstrate a clear understanding of the quality and consistency of decision-making throughout the business, including how decision-making is consistent with the financial institution's risk appetite and the business strategy.

3.1.10 The board and senior management have clear views on the business lines considered to pose the greatest challenges to risk management, such as unusually profitable parts of the business, and these are subject to constructive and credible challenge about the risk-return balance.

3.1.11 The board and senior management systematically monitor how quickly issues raised by the board, supervisors, internal audit, and other control functions are addressed by management.

Learning from risk culture failures

3.1.12 The board and senior management have processes in place to ensure that failures or near failures in risk culture, internal or external to the firm, are reviewed at all levels of the organisation and are seen as an opportunity to strengthen the financial institution's risk culture and make it more robust.

3.1.13 Assessment and communication of lessons learned from past errors is seen as an opportunity to strengthen the institution's risk culture, and to enact real changes for the future.

3.2 Accountability

The board and senior management should establish a policy of ownership of risk where employees are held accountable for their actions and are aware of the consequences for not adhering to the desired behaviours toward risk. In particular, business lines, the risk management function and internal audit should have clearly delineated responsibilities in regard to monitoring, identification, management and mitigation of risk. Accountability speaks to the prompt identification, management, and escalation of emerging and unexpected risk issues, and having a clear understanding of the consequences for not doing so, while retaining ownership of risk with the units originating them. The escalation of adverse events is not intended to transfer accountability of the core issue to other individuals or groups.

Indicators of accountability

Ownership of risk

3.2.1 Clear expectations are set with respect to the monitoring and reporting of, and response to, current and emerging risk information across the institution, including from the lines of business and risk management to the board and senior management.

3.2.2 Mechanisms are in place for the lines of business to share information on emerging and unexpected risks, including horizontally to other business lines and units that might be impacted.

3.2.3 Employees are held accountable for their actions, regardless of whether their actions resulted in financial gain or loss to the financial institution, and are aware of the consequences for not adhering to the desired risk management behaviour.

Escalation process

3.2.4 Escalation processes are established and used, with clear consequences for non-compliance with risk policies and escalation procedures.

3.2.5 Systematic assessments are conducted on whether employees are aware of escalation processes and believe the environment is open to critical challenge and dissent.

3.2.6 Mechanisms are established for employees to raise concerns when they feel discomfort about products or practices, even where they are not making a specific allegation of wrongdoing, and for acting on those concerns.

3.2.7 Whistleblowing is proactively encouraged and supported by the board and senior management, and understood by employees as part of an effective compliance framework; the treatment of whistle blowers is clearly articulated and followed in practice.

Enforcement

3.2.8 Consequences are clearly established, articulated and applied for business lines or individuals engaged in risk-taking that is excessive relative to the financial institution's risk appetite statement, regardless of whether positive revenue or net income was generated.

3.2.9 Breaches in internal policies, procedures and risk limits, as well as non-adherence to internal codes of conducts, impact an individual's compensation and responsibilities, or affect career progression including termination.

3.3 Effective challenge

A financial institution's culture must encourage transparency and open dialogue between (a) management and the board, and (b) management and staff, on all levels and at all points in the process of development, marketing, implementation and maintaining of a product, service or transaction, in order to promote the identification and escalation of risk issues (i.e., make it easy for staff to "raise their hand"). Evidence of a culture that is open to dissent is often reflected in decision-making processes.

Open to dissent

3.3.1 Alternate views or questions from individuals and groups are encouraged, valued and respected and occur in practice.

3.3.2 Senior management has mechanisms in place to ensure that alternate views can be expressed in practice, and requests regular assessments of the openness to dissent at all layers of management involved in the decision-making process.

Stature of risk management

3.3.3 The chief risk officer and risk management function share the same stature as the lines of businesses, actively participating in senior management committees and proactively involved in all the relevant risk decisions and activities.

3.3.4 The chief risk officer and risk management function have appropriate direct access to the board and senior management and effectively utilise it.

3.3.5 Compliance, legal and other control functions, including their respective representatives, have sufficient stature not only to act as advisors, but to effectively exert control tasks with respect to the institution´s risk culture.

3.4 Incentives

The power of a positive culture in risk management lies in its ability to motivate employees to want to control risks because prudent risk taking is valued and enforced. Remuneration systems should reward servicing the greater, long-term interests of the financial institution and its clients, including sustained profitability, as opposed to short-term revenue generation. As such, the risk management and compliance considerations should have sufficient status in driving compensation, promotion, hiring, and performance evaluation within the business units. Compliance with the overall risk management framework should be a significant part of the professional development, appraisal, evaluation, promotion and compensation programs of the institution.

Indicators of incentives

Remuneration and performance

3.4.1 Remuneration and performance metrics consistently support and drive the desired risk-taking behaviours, risk appetite and risk culture of the financial institution, and encourage employees to act in the interest of the greater good of the company, rather than themselves or their business line.

3.4.2 Annual performance reviews and objectives-setting processes include steps taken by the individual to promote the financial institution's desired core values, compliance with policies and procedures, internal audit results, and supervisory findings.

3.4.3 Incentive compensation programs systematically include individual and group adherence to the financial institution's core values and risk culture, including treatment of customers, and cooperation with internal control functions and supervisors, respect to risk exposure limits and alignment between performance and risk.

Talent development and succession planning

3.4.4 Understanding key risks and essential elements of risk management and the culture of the firm is considered a critical skill set for senior employees and reflected in development plans for employees.

3.4.5 Succession planning processes for key management positions include risk management experience and not only revenue-based accomplishments; for instance, the chief risk officer can be considered as a potential candidate for chief executive officer.

3.4.6 Training programs are available for all staff to develop risk management competencies.