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Secretariat to the Financial Stability Board
Bank for International Settlements
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Sent via email: fsb@bis.org

Re: Increasing the Intensity and Effectiveness of Supervision Consultative Document: *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture*

The ACLI[1] appreciates the opportunity to comment on the Financial Stability Board's consultative document, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture* (hereinafter the "*Guidance*") and the accompanying addendum published on December 23. The Financial Stability Board (FSB) published the *Guidance* in response to a recommendation for "supervisors to explore ways to formally assess risk culture at financial institutions, particularly SIFIs," in the November 2012 progress report on *Increasing the Intensity and Effectiveness of SIFI Supervision*.

ACLI appreciates the FSB's efforts to address institutional risk culture, as it is a complex and challenging topic for regulators and supervisors to evaluate. The FSB has identified three foundational elements of sound risk culture – risk governance, risk appetite and compensation. The *Guidance* identifies multiple "indicators" of sound risk culture that support the foundational elements. The four primary "indicators" of a sound risk culture are (1) tone from the top; (2) accountability; (3) effective challenge; and (4) incentives. The *Guidance* provides further examples of each indicator.

Overall, ACLI agrees that the four primary (tone from the top, accountability, effective challenge, incentives) indicators correspond to the hallmarks of a robust risk culture. We also endorse the elements identified by the Financial Stability Board as the foundations of a sound risk culture (risk governance, risk appetite, and compensation).With that in mind, we wish to comment on a few areas where we believe the *Guidance* can be strengthened or clarified.

1. **Organizations can learn from past risk culture experiences, including risk culture success.** ("Tone from the Top")

We agree with the drafters that past experiences are valuable opportunities to strengthen an institution's risk culture and make it more robust.[2] Studying past experiences allows regulators and financial

[1] "The American Council of Life Insurers (ACLI) is a Washington, D.C.-based trade association with more than 300 legal reserve life insurer and fraternal benefit society member companies operating in the United States. ACLI advocates in federal, state and international forums. Its members represent more than 90 percent of the assets and premiums of the U.S. life insurance and annuity industry. In addition to life insurance, annuities and other workplace and individual retirement plans, ACLI members offer long-term care and disability income insurance, and reinsurance. Its public website can be accessed at www.acli.com."

[2] *Guidance*, page 6, paragraph 3.1.12 (Learning from risk culture failures).

institutions to evaluate outcomes and incorporate the lessons learned into future practices and policy development.

The *Guidance* states that one indicator of appropriate "tone from the top" is "learning from past failures."[3] We propose widening the scope of these provisions to ensure that companies are reviewing and learning from *all* past experiences – successes as well as failures. Discussions about past successes can inform and shape sound decisions and actions in the future as well as reinforce positive behaviors and actions. The evaluation of successes, along with failures, allows companies to identify and evaluate successful and unsuccessful strategies to determine which to strengthen and/or replicate and which to modify or discard.

In order to encourage learning from both successes and failures we respectfully recommend modifying the language at page 6 of the *Guidance*. Strikethrough font indicates a deletion, and additions are underlined:

> *Learning from risk culture ~~failures~~ <u>experience</u>*
>
> 3.1.12 The board and senior management have processes in place to ensure that <u>successes and</u> 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~~ <u>experience</u> is seen as an opportunity to strengthen the institution's risk culture, and to enact real changes for the future.

2. **Risk culture and management should be proportional to the complexity of the company and the nature and scale of exposed risks.**

ACLI believes it would be helpful for the *Guidance* to include a clear statement that supervisory expectations are subject to the concept of proportionality. Although systemically important financial institutions ("SIFIs") are the primary subject of the *Guidance*, it is likely that other financial institutions (*i.e.*, non-SIFIs) could become subject to the recommendations within the *Guidance*. While it is important for *all* financial institutions to have strong risk cultures, not all of the specific recommendations in the *Guidance* will be appropriate for all financial institutions, depending on the varying nature, scale and complexity of their business.

3. **Risk culture practices are evolving and the FSB should not freeze risk culture practices in time by becoming too detailed.**

To remain robust, risk culture is not and cannot remain static. Risk culture and best practices advance and grow in response to micro and macroeconomic, technical, societal, and regulatory developments. It is important that financial institutions have the flexibility to adapt their risk culture to new developments.

The *Guidance* provides a total of 33 examples, or "sub-indicators," for the four indicators of a strong risk culture. For the most part, these sub-indicators are principles or outcomes-based, and we believe this is appropriate to ensure that the *Guidance* remains relevant as risk-culture best practices evolve. However, it is concerning that the Public Consultation Questions suggest that the FSB is considering adding a degree of granularity that is inconsistent with the mandate to develop outcomes-based supervision. We would oppose the addition of specific examples.

[3] *Guidance*, page 6, paragraphs 3.1.12 and 3.1.13.

Risk culture and enterprise risk management is a developing discipline that is influenced by a number of internal (company practices and culture) and external factors, such as economic events and the regulatory environment the company is operating in. We are concerned that adding additional examples, particularly of "specific practices" or further elaboration on "risk culture" will ultimately make the *Guidance* less useful, and possibly even outdated.

4. **Risk cultures, like risk management, can take different forms and have the same outcome – robust risk management. The assessment of risk culture should be proportional to the nature, scale and complexity of the financial institution.**

Risk culture is highly specific to each company and will vary depending on the nature, scale and complexity of the risk exposure. Jurisdictional regulations and corporate governance laws also influence risk culture and risk management. The internal and external environmental and economic diversity that companies operate within means that risk culture and best risk management practices can develop and look differently from each other, while still achieving the same outcome of robust risk management.

The concept of proportionality is critical when considering that risk culture and risk management can vary among companies, even among similarly sized companies if the companies have materially different risk exposures. As a result, we think the *Guidance* could be strengthened by advising supervisors that although there are common foundational elements to risk culture, an in-depth analysis of risk culture or decision-making processes are not necessarily well suited for horizontal reviews. Supervisors can use the information provided through risk-culture analysis as an opportunity to gain insight on specific companies and conduct further dialogue with senior management and leadership.

5. **Respect the division between risk supervision and risk management.**

We support the FSB's recognition that supervisors must strike the "right balance between taking a more intensive, proactive approach and not unduly influencing strategic decisions of financial institutions management."[4] However, there are a few places where the *Guidance* appears less mindful of this balance. For example, the *Guidance* states that "[o]utcomes-based supervision involves proactively assessing the decisions of the financial institution based on its strategic vision, business model and risk appetite framework." [5] We think that this sentence suggests a level of supervisory engagement that could lead to undue interference in management decision-making. Supervisors should monitor risk-taking and encourage insurers not to take excessive risk, but unless the supervisor identifies excessive risk-taking that threatens policyholders, the supervisor should not be involved in strategic decision-making or make decisions on behalf of the insurer. With the exception of conditions that are hazardous to policyholders, the supervisors' job is to identify risk, but it is up to the company to *manage* the risk.

With respect to the need to strike the right balance between intensive, proactive supervision and undue influence, we request clarification on the FSB's statement that "[a]ssessing risk culture entails identifying the root cause of *why* there are supervisory findings, not just *what* the findings are."[6] The *Guidance* also talks about supervisors embedding the "underlying *causes"* of findings in reports.[7] We have reservations about directing supervisors to speculate about behavioral motivations, and for reasons discussed above, we also caution against the use of horizontal reviews as a means of obtaining nuanced information about a particular company. We believe robust and honest dialogue with the board and senior management is a better, more effective way to gather this information and insight.

[4] *Guidance*, p. 4.
[5] *Guidance*, p. 1.
[6] *Guidance*, p. 4 (emphasis original).
[7] *Id*.

Conclusion

Overall, ACLI agrees that the four primary (tone from the top, accountability, effective challenge, incentives) indicators correspond to the hallmarks of a robust risk culture. We also endorse the Financial Stability Board's identification of risk governance, risk appetite and compensation as the foundational elements of a sound risk culture. We believe that the *Guidance* is a useful resource to raise awareness of risk-culture amongst supervisors, but the guidance itself should remain flexible and principles based, to allow risk culture to evolve along with shifting environments. We would also request that the *Guidance* consider including language noting that risk culture and management should be proportional to the complexity of the company the nature and scale of exposed risks. We are happy to provide any additional information that may be helpful.

Sincerely,

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