

Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel Switzerland

January 24, 2014

Attention Grace Sone

~~Grace~~
Dear Grace:

I am writing in my personal capacity to provide comments on the FSB consultative document entitled 'Guidance on Supervisory Interaction with Financial Institutions re Risk Culture'.

I believe that risk culture, and culture more generally in financial institutions is a very important determinant of their safety and soundness, treating customers properly, and of their sustainable success. As such, it needs specific attention by boards and senior management, and by forward-looking supervisors. It is also a topic that in my experience is not one where any one of: supervisors; boards and senior management of institutions; or, outside consultants doing culture assessments have a clear monopoly on understanding or clear capability to accurately assess. Culture deals with behaviours and attitudes that can be difficult to assess and interpret. The draft SIE paper in some places reads as if there is a more definitive understanding of these issues, their causes and remedies than in fact exists. Also the paper inadvertently downplays the challenge of using judgement to identify and deal with major culture issues in advance of them becoming serious problems.

My observation and experience is that culture in an organisation requires a high level of judgement by both supervisors and by leaders of financial institutions to properly assess root causes and to lead change, when necessary. That is not always present. As structured, the draft FSB guidance has too high a risk of degenerating into a box ticking, compliance exercise for both financial institutions and supervisors, and of promoting over-reliance on independent survey assessments. These surveys are a useful input, but can be of varying quality and require interpretation by those who understand the institution the best, including its board, senior management and its supervisor. Having this become a compliance exercise would divert attention from the real improvements that need to be made and undermine effectiveness of this effort.

I have five specific recommendations related to the draft document.

First, the various references that suggest that assessing culture is part of every supervisory activity, and needs to be assessed constantly, should be removed. While every supervisory activity provides data that can inform an assessment, actually getting at important cultural issues in an organization requires stepping back, applying high-level consideration, discussion and judgement in identifying themes from several supervisory reviews, discussing with leadership of the institution, and properly identifying root causes. This should be recognised explicitly in the guidance. Without this change, the FSB risks telling supervisors

globally to make culture the overriding point of supervision, which will not be an effective or realistic approach.

Second, the various references to independent assessments should be altered to remove the suggestion that financial institutions should be required to perform frequent assessments of their culture and deal with each of the findings from those assessments. Independent survey assessments are of variable quality, require considerable reflection and interpretation to draw out the most important root causes, and an organisation's culture does not change that frequently. Periodic use of assessments as one, but not the only, input into consideration of culture by the institution is what the FSB should be explicitly promoting.

Third, while the lists of various detailed indicators in the draft FSB document are useful, they themselves, and how they are presented in the FSB paper, risk becoming a box ticking exercise. What matters is whether there is a culture of the right tone from the top, accountability, effective challenge, and incentives, as the FSB paper rightly focuses on. Making judgements about these core elements is more important to assessing culture than determining whether every detailed indicator is fully fulfilled. That is the difference between a consideration of risk culture and the more regular supervisory and governance consideration of the quality and adequacy of risk management and control systems. Often there may be only a few of the detailed indicators that point to a risk culture issue and there may be root causes that lie behind the indicators. Also, much of risk culture is about how the front line operates as a first line of defense, not just about how the control functions work, which is the focus of the draft guidance.

The guidance should explicitly indicate that these detailed indicators should not be used as a checklist but are a starting point for consideration by financial institutions and by supervisors, that supervisors must assess the various indicators they are seeing and make judgements about root causes. Otherwise, the supervisory process risks becoming ineffective. Clarity about how the indicators are to be used should be given prominence in the introductory part of the document and material should be added as a preamble to the detailed indicators section. The FSB should put the detailed indicators in a separate annex to reduce the chance that they become an FSB-sanctioned checklist.

Fourth, as proposed in the recent G30 report that I was associated with, FSB guidance should very clearly mandate that supervisors discuss their observations and potential conclusions on culture issues with senior management and boards of institutions before they reach final conclusions. They should share draft materials with institutions before they formally communicate supervisory findings or opinions related to culture issues in supervisory letters. Otherwise the risk of mis-assessment will too high. Failure to have these discussions also misses the opportunity to engage the board in driving necessary change, which can be a powerful supervisory ally.

Lastly, for risk culture and its assessment by supervisors to be meaningful and effective, there are several things that both institutions and supervisors need to do. FSB guidance affects all supervisors globally. Many of them are at very different stages in their development of capability to assess culture issues. As structured, the draft guidance places all the formal requirements only on institutions. Useful suggestions to supervisors that are contained in the introduction and in section 3 under the heading 'General Supervisory Guidance' should be elevated in the document to formally-structured FSB recommendations to supervisors. A draft

of what this might look like is attached. In some cases it uses statements already made in the FSB document. Without this, many supervisors will not do what is necessary to succeed in this area. The result also could also be mis-directed supervisory requirements on institutions in the name of improvements in risk culture.

I very much appreciate the FSB work in this important area and I would be happy to discuss any of the points in this letter with you.

Regards,

A handwritten signature in black ink, appearing to read "Nick LePan". The signature is written in a cursive style with a large initial "N" and a long, sweeping underline.

Nick LePan

Specific Guidance for Supervisors to Include in Section 3

1. Supervisors in assessing risk culture should adopt a process, periodically, to synthesise supervisory findings, look for common themes, aggregate informal observations they have about the institution, and apply high-level judgement in deciding whether culture is an issue and identifying root causes. Supervisors should recognise that every supervisory activity can add information that informs these periodic assessments, but that single supervisory results are rarely a definitive indicator of culture issues that need to be addressed.
2. Evidence should be gathered from the full range of supervisory activities so as to avoid being perceived and managed as a compliance driven exercise. Evidence from supervisory reviews on culture issues may be further supported by discussions conducted with members of the board and senior management.
3. If there are potential risk culture issues, supervisors must focus on possible root causes in order to form a view on underlying factors that need remediation. The lists of possible indicators included in this guidance should be treated as a starting point for those assessments. Supervisors should avoid supervisory methodologies that treat these indicators as a checklist. Which indicator or indicators is most relevant to a particular situation will vary. In some cases root causes not specifically mentioned in the detailed indicators will be the source of what the indicators are showing.
4. Assessing risk culture requires supervisors to develop broad based experience and the appropriate skill set required for senior level interaction with firms on the role played by risk culture. Supervisors must have staff with training and experienced judgement in making these assessments. They should involve senior staff in the organisation in this assessment process, and in the process of discussion on culture issues with financial institutions, particularly for major complex institutions.
5. Before reaching conclusions, deciding on supervisory action related to risk culture issues or issuing formal supervisory communication with institutions on risk culture issues, supervisors must discuss their views and findings with the institution's senior management and board of directors.