HSBC

Financial Stability Board
fsb@bis.org

31 January 2014

Dear Sirs

Consultative Document – Guidance on Supervisory Interaction with Financial Institutions on Risk Culture

HSBC welcomes the opportunity to provide feedback on the FSB's consultative document on "Guidance on Supervisory Interaction with Financial Institutions on Risk Culture" and is supportive of the approach that has been outlined.

HSBC considers the implementation, assessment and evaluation of a sound Risk Culture within an organisation to be an extremely important matter for consideration. Establishing and maintaining a strong risk culture is of fundamental importance in ensuring the sustainable success of an organisation and to the reestablishment of trust of financial institutions and the banking sector.

High-level Comments

We note that culture and risk culture are very difficult concepts to define; culture as a term needs to be used sensitively, with a clear articulation of what is meant by the term. It is important to acknowledge that it is constantly evolving and, by its nature, difficult to measure. Therefore a focus on values and behaviours are important complementary components of any framework to assess risk culture.

In this context we strongly support the choice of the 4 indicators of a sound risk culture, which substantially address the issue raised above and provide an objective assessment of behaviours and values expected within a defined risk culture.

In addition there are three main themes that we wish to provide feedback and comment: (1) definitions (2) governance (3) roles and responsibilities.

HSBC Holdings plc
Group Risk, Level 30, 8 Canada Square, London E14 5HQ
Tel: 020-7991 8888 Fax: 020-7991 4603

(1) Definitions

The guidance document would benefit from greater clarity on the definitions around the concepts of culture and risk culture. This is key to ensuring consistency of use of terminology and understanding. This additional clarity would greatly assist in ensuring that supervisors are able to undertake consistent and focused assessments of risk culture.

The guidance paper does not articulate what it regards to be good or bad risk culture. Whilst we recognise that risk cultures may differ across organisations or within an organisation, it would be useful to provide either attributes or examples of behaviours which may be observed in a good or bad risk culture.

We believe that the provision of clear definitions and articulation of good and bad constructs and behaviours would help the understanding of appropriate risk cultures and would create the framework necessary to support supervisors as they undertake a principles-based assessment. In our opinion that would be more effective, for both supervisors and organisations, than a rules based approach. In addition whilst it is recognized that a one-size-fits-all approach is unlikely to be appropriate for risk culture, financial institutions operating on a cross-border basis will be likely to be able to implement a globally embedded risk culture, aligned to group-wide cultural and behavioural values if there is supervisory convergence on this matter, rather than local initiatives responding to local regulatory interpretations.

(2) Governance

The guidance document very helpfully notes the need for an effective risk governance framework. In additional we suggest that the paper provide more guidance on principles which should be embodied within an effective governance framework to effectively manage, monitor and assess the risk culture across an organisation. While this should not be too prescriptive it would serve to emphasize that in addition to the specific remuneration process, organisations need to explicitly consider their culture and observed behaviours and, within the formal governance process, assess their impact and agree required actions.

The assessment of risk culture in most organisations does not occur in one central point but rather is undertaken through various processes across different functions. We therefore propose that more detailed principles of the governance framework would provide supervisors with a more holistic insight for their assessment purposes.

(3) Roles and responsibilities

In relation to the point above, whilst the FSB Thematic Review on Risk Governance is referenced in the paper, benefit would be gained from more clearly articulating the roles and responsibilities of the Board, Senior Management, the Business and Control functions with respect to risk culture, in order to provide supervisors with clear expectations of accountability and responsibilities. In addition the paper would also benefit from clear guidance on the role that supervisors should take in their interactions with the board, to ensure that the supervisors' activities do not unduly influence decisions or actions of the board. It would be helpful to provide this articulation in the context of the three lines of defence model, which many organisations have adopted to embed the ownership of risk across the firm.

Detailed Comments

Additional, more detailed comments on the consultation paper are included in Appendix 1. The responses to the questions that were issued for Public Consultation are included in Appendix 2 of the document.

We would be pleased to discuss our comments with you further bilaterally.

Yours faithfully,

Alan Smith

Alan N Smith
Global Head of Risk Strategy & Chief of Staff, Global Risk

Appendix 1 – Detailed comments on the Consultative Paper
Appendix 2 – Responses to the Questions issued for Public Consultation

Appendix 1

Detailed comments on the Consultative Paper

Introduction (page 1)

"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."

Whilst we support and welcome increased supervisory interaction with the board and senior management, there is a danger that the current wording may result in the supervisors becoming "shadow directors" and involved in the decision making process.

1. Foundational elements of a sound risk culture – Compensation (page 3)

"Compensation should take into consideration prospective risks as well as risk outcomes that are already realised."

The wording could be interpreted to mean that compensation should be based on prospective risks, which we would not consider to be appropriate, since current compensation should not be based on future events. It is therefore suggested that the wording is revised to reflect that compensation should take into account employees' consideration of emerging risks.

3. General supervisory principles (page 4)

"Assessing risk culture entails identifying the root cause of why there are supervisory findings – not just what the findings are"

"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."

We recognise that supervisors should constantly engage with organisations to inform their understanding of risk culture; however we believe it is the role of the board and senior management to constantly assess the risk culture indicators and observed behaviours and not that of supervisors. The constant assessment of the risk culture by supervisors may lead to loss of objectivity and we would therefore propose periodic assessments in order to maintain an objective view.

Further, the primary responsibility for root cause analysis of issues identified should rest with the organisation.

3.1 Tone from the Top (page 5)

"Non-executive directors can play an important role in bringing experience from other industries where behaviours and practices generally necessitate a sound risk culture"
Whilst we recognise that diversity of experiences may bring about fresh perspectives and avoid tunnel vision, it is our view that the board experience of financial services should not be watered down. We would therefore propose that the wording is revised to reflect that there is a balance to be struck between diversity and ensuring financial services experience.

3.1.10 Ensuring common understanding and awareness of risk (page 6)

"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."

While it is important to challenge unusually profitable parts of the business as part of a robust risk culture, it is equally important to encourage a mind-set which realises that there needs to be strong focus on non-financial risks which might not necessarily lend themselves to immediate and easy quantification. This point could be added to the guidance.

3. Learning for Risk Culture failures (page 6)

"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."

The text should be clarified to explain that it is not risk cultures that fail, but rather a weakness in risk culture that that gives rise to failure to effectively manage risk. It would also be helpful to provide a definition of failure.

3.3 Effective Challenge (page 8)

There is no mention of internal audit and its role in creating effective challenge in discharging it's responsibilities in the third line of defence. We therefore would propose that a reference internal audit and its role is included in the effective challenge section.

3.3 Effective Challenge (page 8)

"Evidence of a culture that is open to dissent is often reflected in decision-making processes."

The evidence that is used to measure "effective challenge", should not just reflect output from governance meetings, but also needs to take into account broader interactions and processes.

3.3 Effective Challenge (page 8)

"Open to dissent"

"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."

The use of the word "dissent" implies that negative action is being encouraged. We would therefore propose that "dissent" is replaced with the "robust challenge", in order to stress the importance of positive action being taken.

3.3.5 Stature of risk management (Page 8)

"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."

The wording seems to suggest that Compliance and other control functions, primary activity is to act as advisors. We have a strong view that these functions should first and foremost act as a risk control function and then secondly, and to a much lesser extent, an advisory function. It may also be helpful to refer more broadly to the Risk function, rather than just Compliance.

Many organisations have adopted the three lines of defence model and we believe that the responsibilities of the second line of defence, which would include the control functions, is to set policy, provide oversight and challenge activities of the first line of defence.

3.4 .5 Talent development and succession planning (page 9)

"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."

It may be useful to expand the example to include consideration of chief risk officer as a potential candidate as Chairman of the Board given the skill set required. We also believe that given the risk function is key to influencing the risk culture, it is essential that it continues to attract talented individuals with a diverse skill set and background.

Appendix 2

<u>Responses to the Questions issued for Public Consultation</u>

General questions

1. Are there areas not addressed in the Guidance that should be considered in assessing risk culture?

The paper provides a comprehensive view of the foundational elements which need to be in place in order to provide a sound risk culture, as well as a sufficiently comprehensive set of indicators of a sound risk culture.

2. Are there areas of the Guidance where further elaboration or clarity would be useful, without becoming too granular?

Following the review of the guidance document, there are three main areas that would benefit from further clarification in the document. (1) definitions (2) governance (3) roles and responsibilities of the board, senior management and supervisors, as discussed in the our letter and appendix 1.

3. Would the Guidance benefit from further elaboration on the definitions of corporate culture, risk culture and sub-cultures within business lines, and on the relationship between them?

As per point 2 above, the guidance document would greatly benefit from the clearer definitions of these concepts and recognition of the difference between them. It would also be useful to recognise that all cultures continuously evolve hence culture appropriate structures which enable and enforce appropriate behaviours over the long term are key to the assessment of the culture. Additionally, national culture will impact embedding an effective risk culture within an organization, and attitudes of supervisors, re-inforcing the need for greater consistency of definition.

4. What tools would assist, in particular supervisors, to effectively assess the risk culture of financial institutions (e.g. interviews, questionnaires, analyses of internal documents such as board self-assessments, code of ethics for employees, risk appetite statements)?

The tools that we would consider to be most relevant and useful to effectively assess risk culture may include:

- Site visits
- Observed effectiveness of governance processes – internal audit reviews and focussed supervisory reviews
- Reviews of root cause analysis when problems occur and approaches to remediation and prevention of re-occurrence
- Interviews held at all levels across the organisation

- Assessment of risk appetite statements and integration of risk appetite within risk culture
- Assessment of quality of Risk reporting to the Board and senior management
- Assessment of the quality of the code of ethics for employees
- Assessment of the quality of the orginisational Policy Framework
- Review of remuneration decisions
- Results of employee surveys and workshops
- Appraisal / Exit interviews
- Analysis of whistle-blower lines
- Mystery shopping
- Self – certification
- Board self-evaluation
- Risk framework annual reassessment and management of emerging risks

5. What is the expected supervisory response if, for example, the board of directors failed in its responsibility of setting the adequate tone from the top and consequently in promoting a sound risk culture?

It would be expected that the supervisors would engage with the board to discuss and understand the nature and extent of such a failing, as well as then agree an appropriate remediation plan to address the failing. It would be useful to provide a clear definition of "failing".

6. What suggestions do you have to improve the engagement of supervisors with financial institutions on risk culture, in particular when discussing the underlying causes of behavioural weaknesses?

The engagement with supervisors could be improved by financial institutions clearly articulating roles and responsibilities appropriate to their organisational structure, which is subject to supervisory review and challenge. In addition a clear articulation of the governance framework that financial institutions have in place will help provide more holistic engagement.

We also believe it is important to have a clear distinction between the roles of the financial institution, which is to investigate and remediate issues, versus that of the supervisors, which is to review and gain satisfaction that the process is functioning effectively.

Further, supervisors could usefully share behavioural weaknesses they have observed across the industry so that organisations could evaluate the likelihood or presence of those behaviours in their own organisations and proactively act to eliminate such behaviours.

Indicators of a sound risk culture

7. Are the indicators identified in the Guidance sufficient for assessing risk culture and adequately capturing the multifaceted nature of risk culture?

We believe that the 4 indicators that have been identified are sufficiently comprehensive and sufficient for assessing the risk culture.

8. Are there specific examples of good practices that can be used to support the indicators?

We believe that good practices would vary widely across the industry and therefore do not wish to limit to a few specific examples.

9. Are the indicators identified in the Guidance commonly considered by the board and senior management when internally discussing risk culture? Are there other indicators that should be included?

The indicators are reasonable ones.

10. Does the paper appropriately describe the different roles of the board, senior management and other control functions in relation to defining, implementing and monitoring risk culture?

As described above the paper would benefit from providing more on the principles that should be applied to the roles of the board, senior management and other control functions in relation to further clarify their differentiated and ongoing responsibilities in defining, implementing and monitoring risk culture.

11. What tools or processes are used to make risk culture tangible within the organisation?

The Risk Appetite Framework and Governance process and its embedding at all levels of the organisation will help to make the risk culture tangible by prompting and enabling the right understanding and conversations at all levels. We would expect that the Risk Appetite Framework would provide a good mechanism for gauging the implementation of the risk culture across the organisation. An organisation would also constantly communicate to increase understanding and demonstrate desired behaviours and encourage discussion on topics such as values, global standards and risk appetite. This communication should include case studies around both good and bad behaviours. Additional tools may also include, induction training, mandatory ongoing training and remuneration policies. An appropriate governance structure should be set up to monitor and provide assurance around the implementation of these enablers of the establishment of the appropriate risk culture across the organisation.

12. Are there useful descriptors of an institution's risk culture, both good and bad, that would be helpful to include in an attachment to the paper? For example "growth for growth's sake" or "it's someone else's problem".

The examples provided above are useful descriptors, in addition it would be helpful to provide the attributes and behaviours that supervisors would expect to assign or observe in either a good or bad culture. These should tie into the indicators of tone from the top, accountability, effective challenge and incentives and therefore be recognised as evidence of a good/bad risk culture.