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RE: FSB Guidance on Supervisory Assessments of Risk Culture

Dear Mr. Andresen:

The Institute of International Finance (IIF)[1] and the Global Financial Markets Association (GFMA)[2] are pleased to have the opportunity to provide comments on the consultative document on the *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture (FSB Guidance)*. The industry fully supports the Financial Stability Board's (FSB) work to improve the effectiveness of supervision, incorporating risk culture as a key dimension. This is a topic of great priority for the industry as evidenced by industry-led discussions (such as the July 2013 IIF Symposium on risk culture with supervisors) and a number of studies and reports that have been produced.[3] The industry hopes that such input and exchange will continue to inform understanding about fostering effective risk culture in financial institutions.

[1] The Institute of International Finance, Inc. (IIF) is a global association created in 1983 in response to the international debt crisis, but has evolved to meet the changing needs of the international financial community. The IIF's purpose is to support the financial industry in prudently managing risks, including sovereign risk; in disseminating sound practices and standards; and in advocating regulatory, financial, and economic policies in the broad interest of members and foster global financial stability. Today the IIF has more than 450 members headquartered in more than 70 countries. For more information, please visit www.iif.com.
[2] The Global Financial Markets Association (GFMA) brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, visit http://www.gfma.org.
[3] Including: IIF, *Final Report of the Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations,* July 2008; IIF, *Reform in the Financial Services Industry: Strengthening Practices for a More Stable System,* December 2009; IIF, *Implementing Robust Risk Appetite Frameworks to Strengthen Financial Institutions*, June 2011; IIF, *Governance for Strengthened Risk Management,* October 2012; and IIF and EY,

The IIF and GFMA would also like to underscore their agreement with the view that a strong risk culture is essential for effective risk management and in the long run global financial stability. A recent IIF and EY survey shows that banks are keenly assessing their risk culture,[4] and although they are taking different approaches to assess it, what stands out is the degree of momentum behind taking action. The survey indicates that more than 85% of North American banks have programs to assess internal culture, and the figure is similar for Latin America. In Europe and Asia-Pacific, 60% or more banks have programs to assess internal risk culture.[5] Evidently, the level of momentum to identify and improve risk culture within firms has improved substantially since the recent financial crisis, and financial institutions hope to do more.

Ultimately, the industry believes that the concept of risk culture, which is mainly behavioral, continues to evolve and as a result, there will be further adjustments and evolutions in different organizations and jurisdictions over time, to enhance risk culture effectiveness based on business models and particular circumstances. Thus, the industry is concerned that standardization of risk culture practices could hinder the overall dynamism that is required for effective risk culture practices to evolve over time. This view informs the comments provided in this response note.

The following comments are categorized into Part I and Part II. Part I focuses on high-level comments about the FSB Guidance and specific comments about the indicators outlined (in numerical order) by the FSB. Part II is an annex section that addresses the specific questions raised in the *Questions for Public Consultation* published on December 23, 2013.

Part I

High-level comments:

The FSB Guidance is a very thoughtful and comprehensive discussion about embedding effective risk culture within financial institutions. The five points identified below reflect the industry's additional overarching thoughts that would be useful to consider, to help foster robust risk culture.

1. Adequate consideration of the challenges of assessing risk culture - Risk culture is primarily behavioral. As a result, it tends to be a very challenging element to identify, measure, and assess. Developing a strong risk culture within a firm is a complex undertaking.[6] Hence, the industry would like to emphasize that the process of "hardwiring" and embedding desired risk behavior into a firm needs to be seen as a multi-year, iterative process, and this should be considered in any supervisory framework that incorporates risk culture assessments.

Remaking Financial Services: Risk Management Five Years after the Crisis – A Survey of Major Financial Institutions, July 2013.

[4] Institute of International Finance and Ernst & Young, *Remaking Financial Services: Risk Management Five Years after the Crisis - A Survey of Major Financial Institutions*, July 2013. Pg. 1 [Available at: http://www.iif.com/regulatory/]

[5] Ibid.

[6] IIF, *Governance for Strengthened Risk Management,* October, 2012. Pg. 1

2. Avoid prescriptiveness - Firms will inevitably have different approaches to embedding risk culture. As a result, the risk culture indicators outlined in the FSB Guidance should not be prescriptive, to allow firms the flexibility to cater various approaches to their own structures and business models.

3. Avoid box-checking supervisory approaches - Owing to the behavioral nature of risk culture (noted above), supervisory assessment of risk culture should not be a mechanical procedure, but rather embedded as a qualitative element in the existing supervisory interactions with the board and senior management of an institution, and perhaps supplemented by a separate dialogue on risk culture. Such 'box-checking' exercises have the potential to 1) overwhelm management and boards, 2) distract from a more fulsome understanding of risks, 3) can take time, which might otherwise be spent thinking about potential new risks, and blocking and tackling on a dynamic basis, and 4) make boards and management more focused on regulatory compliance in and of itself.

4. Supervisory culture - Following from Point 3 above, supervisors should develop a supervisory culture that is less compliance-driven and more holistic. A holistic approach to risk culture looks at the entirety of an organization and its risk culture practices in various pockets and levels, to develop a well-rounded view.

   Furthermore, the industry would like to note that supervisors, in many cases, are well placed to make effective use of information they gather from institutions, particularly when applying a holistic approach based on information drawn from different areas of institutions. Depending on the jurisdiction and how the regulator may be organized, they may well have a unique vantage point across the organization, but using this to inform their view on risk culture may require some effort on the regulator's part to pull the disparate information together and view it all through a risk culture lens. In addition, the regulator certainly has a unique view across different firms and can perform peer analysis in order to inform both itself and firms on how the industry landscape looks and suggest issues for firms to look at.

5. Materiality and proportionality – The industry believes that it is vital to investigate risk culture failures in all areas of the firm. Particularly, managers have to respond to all levels of risk culture failures to ensure that failures that seem minor do not become full-blown organizational challenges. Hence, while it is important for supervisors to encourage managers to address all types and levels of risk culture failures, application of materiality and proportionality noted in the FSB's *Principles for An Effective Risk Appetite Framework* ("FSB Principles") to supervisory assessments of risk culture will be appropriate. The FSB Principles also noted "materiality should be determined by financial institutions, and discussed with supervisors, in accordance with their internal assessments of risk appetite, risk capacity and risk profile, having regard to capital, liquidity and earnings at the entity level."[7] A similar approach could be used in determining the appropriate supervisory responses to different levels and categories of risk culture failures. Essentially, the risk culture indicators and supervisory assessments

[7] FSB, *Principles for an Effective Risk Appetite Framework,* November 18, 2013. Pg. 1

should be applied at the business line and/or legal entity level in a manner that is proportional to the size of exposures and materiality of the risks involved.

Foundational elements of a sound risk culture

The key areas identified in the FSB Guidance, as the *foundational elements* that contribute to promoting a sound risk culture are quite paramount and need significant attention by institutions. The IIF has contributed responses to consultations on these areas, more recently responding[8] to the FSB's consultation on *Principles for an Effective Risk Appetite Framework,* which underscores the importance of developing risk appetite frameworks, risk appetite statements, risk limits, and defines the key roles and responsibilities of the board and senior management in establishing risk appetite statements.

In addition, the following non-exhaustive points highlight other areas that are foundational to the development of a sound risk culture in an institution and are worth considering.

1. Importance of the first line of defense - Each business within an institution carries a significant responsibility in managing its risk. The widely held *three lines of defense* approach to risk management begin with the line management as the *first line* of defense,[9] mainly because it has primary responsibility for day-to-day risk management. This concept should be reflected as part of the foundational elements of a sound risk culture.

2. Role of the compliance function - The compliance function of an institution plays a significant role in the context of risk management. A compliance function that confirms good adherence to all rules and regulations can be an effective barometer in determining the strength of risk culture. Further, a robust compliance function would also educate employee groups and provide awareness of the spirit of the rules and regulations governing the organization, thereby promoting an appropriate risk culture throughout the organization. Hence, an effective supervisory framework that incorporates risk culture as a dimension should also take into account the effectiveness and robustness of the compliance function.

3. Sensitivity to external perceptions - A firm's risk culture could benefit from a strong understanding and awareness by the firm as to how such culture is perceived externally. This includes perceptions from the media (including social media), clients and the community at large. External perceptions could positively reinforce the efforts by individual firms to reinforce their risk culture, and perhaps corporate culture more broadly. This understanding, while useful, needs to be considered and assessed by each firm and should not result in either complacency or in an overly extensive focus on the perception of its risk culture over the risk culture itself.

4. A forward-looking approach towards risk management – A difficult but relevant task of a firm is to avoid complacency and remain vigilant. That is to say, while it is important for firms to revisit past failures, learn from them, and avoid repeating them, it is equally

[8] IIF's Response to FSB's *"Principles for Effective Risk Appetite Framework,"* September 30, 2013
[9] Ibid, Pg. 37

important to attempt to determine and constantly learn about what challenges or failures may develop over time. That is a very challenging task and may require a learning community of practitioners, academics, clients, and supervisors, that a firm may frequently gain input from particularly on understanding evolutionary changes in the industry and concomitant risks. An institution with such a forward-looking attitude or view towards risk management (for example rethinking how internal modeling is conducted) will likely have a stronger risk culture and may be able to steer clear of some avoidable risks that have the potential to lead to systemic crises. In any event, such an approach must be conducted to reflect an institution's specific context and circumstances.

Specific comments on Section 3 (general supervisory guidance on indicators):

The industry has previously highlighted that it is necessary to promote a strong culture of cooperation with supervisors.[10] That is to say on the one hand, firms must ensure that supervisors are kept informed of material developments, and on the other hand, supervisors for their part need to communicate effectively so that perceived deficiencies are shared with the firm before they become the subject of supervisory reports, let alone give rise to early intervention.[11] In that regard, section 3 of the FSB Guidance (under *General supervisory guidance*), which notes that the underlying causes of supervisory findings should be embedded in supervisory reports and discussed with the board and senior management[12] should in fact be a discussion in the spirit of the cooperative relationship already fostered between an institution and its supervisor.

In addition, instead of "high-level skeptical conversations with the board and senior management"[13] about a firm's risk culture, a more open conversation that builds on an established culture of cooperation between an institution and its supervisors would be more meaningful.

Tone from the top (3.1)

The industry strongly agrees that the attitude of the board and senior management in promoting appropriate risk-taking behaviors is a critical element in fostering a sound risk culture. However, as the FSB Guidance notes, "For lasting change, the tone and behaviours 'in the middle' and indeed throughout the institution, is also important."[14] The industry would emphasize here that while the tone from the top is important, in a large institution in particular, the 'tone at the middle' is a key element and perhaps a more efficient way to enhance risk culture. The 'tone at the middle' is a critical piece of fostering an effective risk culture because it is an important channel through which risk culture practices are cascaded further down an organization. It is the point where middle-level managers transmit the culture that is derived from leadership, as they execute day-to-day affairs. Additional focus by the FSB on this area would be very helpful in enhancing the discussion on risk culture. It is worth noting that recent

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[10] IIF, *Achieving Effective Supervision: An Industry Perspective,* July 2011. Pg. 29
[11] Ibid.
[12] FSB Guidance, Pg. 4
[13] FSB Guidance, Pg. 1
[14] FSB Guidance, Pg. 5 (3.1)

academic research also supports the high importance of the 'tone at the middle' in enhancing risk culture.[15]

A focus on both 'tone from the top' and 'tone at the middle' is not inconsistent. Essentially, the board and senior management set the tone, but the day-to-day messages are usually transmitted from middle management, to provide consistency and reinforcement to the 'tone at the top.' It would be beneficial for supervisors to assess 'tone at the middle,' particularly looking at the kind of language that is spoken at the mid-level.

Current regulatory proposals have been placing increasing management responsibilities on the board, which may not be useful. Adequate differentiation between what one would expect from the board versus what one would expect from senior management and middle management would be helpful. As indicated in the Annex (Part II) section, the board of directors plays the fundamental role of oversight of the firm, but does not manage the firm, which is precisely the role of senior management.

<u>3.1.5 (Talent development and succession planning)</u>:

1. This section requires firms to have mechanisms on talent development and succession planning to limit the influence of dominant personalities and behaviors. Although such mechanisms may help to lessen the influence of dominant personalities, an institution should already have an established system of checks and balances for the decision-making processes. In addition, it is crucial that talent development, hiring processes, succession planning and appointment, already in place for middle management positions, are based on a formal and comprehensive risk assessment of candidates particularly in business and risk networks. The comprehensive assessment should consider risk knowledge, risk experience, performance of past risk decisions and risk behavior and attitude. Also, *talent development,* embedded in various sections of the FSB Guidance, should perhaps get its own section as it is a critical element of enhancing risk culture.

2. Furthermore, the FSB could consider the influence not only of dominant personalities in senior management, but also how the business model and organizational structure will impact and shape culture. The G-30 report, *A New Paradigm: Financial Institution Boards and Supervisors,* makes the key point that an institution's culture is closely aligned with its business model and that "management, boards, and supervisors should carefully consider whether the business model reinforces a healthy culture."[16] The industry would encourage the FSB to consider organizational culture more generally as risk culture is a sub-set of organizational culture but focuses on the implications that organizational culture has for risk awareness, risk taking, and risk management (or looking at the organizational culture through a risk lens).

[15] This includes research conducted by Associate Professors Elizabeth Sheedy (specialist in Financial Risk Management) and Barbara Griffin (specialist in Organizational Psychology) with the Center for International Finance Regulation (CIFR), based in Macquarie University's Applied Finance Centre, in Sydney Australia.
[16] G-30, *A New Paradigm: Financial Institution Boards and Supervisors,* October, 2013. Pg. 38

3.1.7 (Mechanisms to assess clarity of risk appetite):

1. This section notes that the board and senior management ought to have mechanisms in place to assess whether the risk appetite statement and strategy are clearly understood and embraced throughout the different levels of the firm. However, practically, it is challenging for the board on its own to ensure that risk management strategies are effectively embedded at the operational and decision-making level. Hence, additional mechanisms such as the 'tone at the middle' are an effective way to enhance risk management strategy and overall risk culture.

2. Further, mechanisms to assess whether risk appetite statement, risk management strategy etc. are understood "at all levels" of management and staff should reflect some level of materiality and proportionality as indicated in the *high level comments*. Thus, section 3.1.7 could be revised to read "at all **relevant** levels" to reflect this concept of materiality and proportionality.

3.1.9, 3.1.10, and 3.1.11 (Communication of risk culture):

1. These sections, clearly related to ensuring common understanding and awareness of risk, speak to the communicative aspects of risk culture. This difficult task of clarifying and communicating risk appetite to all relevant levels of an organization requires focused attention. It involves communicating internally to the front office colleagues, back office colleagues, and the like. It also involves applying multiple tools including digital tools to start conversations about risk management issues. This is a long-term, time-consuming effort that requires constant focus, but goes a long way to enhance risk culture.

2. Section 3.1.11 in particular states that board and senior management systematically monitor how quickly the raised issues are addressed. However, time may not be the right metric. It would be more appropriate to consider adequate follow-up and remedial actions.

3.1.12 (Review of risk culture failures):

1. While it is necessary that reviews of risk culture failures are very vital to developing pertinent risk management lessons as section 3.1.12 notes, the section should reflect that such reviews need to be conducted "at all **applicable** levels" of the organization, instead of "at all levels". This incorporates a level of materiality and proportionality that is useful to consider.

Accountability (3.2)

The FSB Guidance underscores the importance of accountability in enhancing a risk culture, noting that 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 behaviors.[17] This is a generally useful approach however the FSB could consider the following additional points.

1. The accountability of the risk taker (the front office or line business) for adherence to the organization's risk appetite and risk management policies should also be at the core of the firm's risk governance framework.[18] Since the business line plays a central role in risk taking, holding the business line accountable in particular, contributes significantly to enhancing risk culture within an institution. This emphasizes the point about the *first line of defense,* raised under the *foundational elements of a sound risk culture,* above.
2. Further, to the extent that the board is engaged in the key decisions about accountability and ownership of risk, there should be follow-up and regular reporting to the board as well to ensure that decisions are followed through and the board is kept aware of consequences of its decisions.

<u>Escalation process (3.2.4, 3.2.5, 3.2.6 and 3.2.7)</u>

- While financial institutions have processes and policies in place to ensure proper risk taking, or in line with the institution risk appetite, it is unclear how an effective escalation process can be designed. In particular, if clear consequences for non-compliance to the escalation procedures need to be established, it would be helpful to receive illustrative examples of how decisions may be eligible for escalation.

<u>Enforcement (3.2.8)</u>

- This section suggests that consequences for excessive risk taking should be clearly established. However, since every situation of excessive risk taking is unique, it would be very difficult to boilerplate consequences. As a result, judgment must be used in different situations. Essentially, possible consequences should be clearly established, but should also recognize that management judgment is needed to determine the right actions to be taken in each unique situation.

<u>Effective Challenge (3.3)</u>

As part of a healthy culture, members of senior management should demonstrate that they are willing to collect alternative views and to be challenged on the basis of the risk framework, and to challenge others. On the other hand, staff should be encouraged to raise potential risk issues and provided with the appropriate channels to do so. Constructive challenge is a welcome objective. [19] However, the industry has identified the following points about the effective challenge indicator for clarification and consideration.

<u>3.3.2 (Open to dissent – "mechanisms" to ensure alternative views can be expressed)</u>:

1. It is unclear what "mechanisms" implies in the context of section 3.3.2. While financial institutions have policies in place to ensure that alternative views can be expressed, and would assume that that is what is meant by "mechanisms" here, it is unclear what

[17] FSB Guidance, Pg. 6 (Sec. 3.2)
[18] IIF, *Governance for Strengthened Risk Management,* October 2012. Pg. 37
[19] Ibid, Pg.10

supervisors would specifically be looking for in their risk culture reviews. Illustrative examples demonstrating this specific point would be very meaningful.

3.3.3, 3.3.4, and 3.3.5 (Stature of risk management):

1. In the context of structuring the appropriate reporting lines to the CRO and to the board to improve effective challenge in an institution, the other risk management functions, including operational risk, credit risk, compliance risk, and market risk should share in the responsibility of providing effective challenges that can be transmitted via the CRO to the board and senior management. This can be done through a reporting framework that feeds into the reporting line to the CRO, and in turn to the board and senior management.

2. Furthermore, the extent to which the CRO is involved in key decision-making and activities would depend on his or her role with the board and senior management. Whether the CRO has a seat at the decision-making table, or a member of the executive committee, or has a bilateral relationship with the chair of the supervisory board, makes a significant difference in how the role can provide input towards decisions and activities or challenge certain decisions. However, what is essential is that a variety of equally valid approaches, tailored to the specificities of each firm, be acceptable as long as they ensure that the views of the CRO can directly influence key decisions that affect the risk profile of the firm.

3. In addition, a firm that is committed to investing in its risk management organization by providing training or professional qualifications to the members in its risk function, will inevitably boost the stature of the risk function and provide great confidence, particularly when the board relies on the risk function's expertise and experience.

4. In any event, the wording in the FSB guidance with regard to the chief risk officer and risk management functions sharing "the same stature as the lines of businesses" indicated in section 3.3.3 is unclear. In terms of rank in the organization, the CRO and other risk functions do not practically share the same rank. It would be useful to have clarity on how supervisors would assess the term "same stature" in the context of effective challenge. However, the industry would emphasize that there should be congruence between the CRO's mandate and the mandate of the function that sits underneath the CRO. Clearly, the organizational intent to equip and allow the CRO and teams to deliver into that mandate is critical.

Incentives (3.4)

Overall, compensation arrangements that are aligned with desired institutional behavior is a powerful means of reinforcing risk culture, and employees within an institution can be given incentives to behave in ways consistent with the firm's risk culture.[20] It also sends a firm-wide message about the commitment of management to maintain a risk-sensitive culture. The recent IIF and EY survey[21] shows strong consistency in the initiatives under way to strengthen risk

[20] Ibid, Pg. 15
[21] IIF-EY Survey, Pg. 9

culture. According to respondents' reports, "aligning compensation with risk-adjusted performance metrics," is one of the top four initiatives being undertaken by institutions.[22] The indicators thus proposed in the FSB Guidance, provides a strong overarching set of principles to observe as institutions undertake these changes.

1. The introductory part of section 3.4 states that "risk management and compliance considerations should have sufficient status in driving compensation, promotion, hiring, and performance evaluation within the business units."[23] However, although risk management and compliance considerations should be factored into decisions in these areas, they should not exclusively drive them. Such considerations need to be balanced within an overall context of risk culture. Ultimately, the essence of risk culture is that it is motivated not really by awards or fear of consequences, but by internalization of an organization's values such that individuals naturally align themselves with those values.

2. Section 3.4.5 (*talent development and succession planning*), which is an indicator that looks at the inclusion of risk management experience in succession planning processes for key management positions, is very useful. However, it lists an example of the CRO being listed to succeed the CEO as an indication of consideration for risk management experience in succession planning. There is concern that this example may confuse the issue and make it seem as though institutions must list CROs as CEO candidates to show adherence to the FSB Guidance. It may be useful to exclude this example to avoid the confusion.

3. Although the indicators are very useful, there are similar but more detailed and prescriptive regulations proposed in EU regulations, related to the CRD IV rules.[24] There is considerable distance between the useful indicators and principles expressed in the FSB Guidance and the prescriptive elements in the CRD IV rules, which needs some attention by the FSB. The industry would emphasize the importance of maintaining the FSB guidance principles-based approach and the role of the FSB to foster more consistent principles across jurisdictions, including the avoidance of excessively rigid and prescriptive approaches that could hinder a range of valid approaches and practices within the industry.

4. Other new emerging approaches to compensation have been developing in financial institutions, where differential compensation arrangements within functions are designed. In some institutions, the reward mix for the CRO is arranged differently from that of other functions. It promotes independence of the risk function to drive an improved risk culture. There are other equally valid forward-looking methods being employed by firms and reflects the internal dynamism within firms as risk culture elements evolve, within the industry. Avoiding standardization in this area will provide institutions with enough latitude for useful innovative approaches to evolve and emerge.

[22] Ibid.
[23] FSB Guidance, Pg. 8
[24] Official Journal of the European Union, *Directive 2013/36/EU of the European Parliament and of the Council,* June 26, 2013.

3.4.6 (Training programs):

1. It is encouraging to see indicator 3.4.6 regarding training programs available for staff to develop risk management competencies. The IIF has previously noted that implementing a formal risk education program is an important step in establishing and implementing a strong risk culture and creates an opportunity to create and promote shared understanding about risk based on a common language.[25] Such common language and concepts can be embraced at all levels to complement the main objectives identified within the institution's risk management and strategy approaches. Such training should particularly be emphasized during orientation of new employees to enhance familiarization with the major risk culture concepts of an institution.

Conclusion

The FSB Guidance on risk culture contains a very useful set of indicators and principles that will continue to enhance the work on improving risk culture already underway within financial institutions, including different approaches, assessments, and enhancement techniques that are equally valid. The points raised in this response note are meant to enhance the discussion about effective risk culture that encourages appropriate risk-taking and in turn fosters a robust global financial system. The IIF and GFMA look forward to continuing interaction and exchanges with the FSB and other policy makers on this important topic.

Sincerely,

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David Strongin
Executive Director
Global Financial Markets Association

[25] IIF, *Governance for Strengthened Risk Management*, October 2012. Pg. 15

Part II

Annex: Response to FSB Questions for Public Consultation

The industry fundamentally believes that exhaustive lists, examples, indicators and practices provided in supervisory guidance while helpful for illustrative purposes, will need to be considered in the context of the wide range of valid approaches to risk culture across organizations and jurisdictions, which are significantly influenced by individual business models. Consequently, practices should not be standardized or universalized to achieve consistency, since different approaches can be equally valid. Effective risk culture will have to be considered within each institutional and jurisdictional context to be relevant to the kinds of risks each institution undertakes. This fundamentally informs the industry's approach in contemplating the following questions, particularly questions 7 -12 below.

General questions

Question 1 (additional areas to be considered in addressing risk culture)

- The industry would highlight the high-level comments outlined in the opening of this response letter as additional areas for consideration in addressing risk culture among financial institutions. These are:
  - Adequate consideration of the challenges of assessing risk culture;
  - Avoid prescriptiveness;
  - Avoid box-checking supervisory approaches;
  - Supervisory culture; and
  - Materiality and proportionality.
- Additionally, the industry would like to emphasize the following issue (also noted in the opening of this response):
  - *Role of business lines in risk culture assessments* – Significant consideration should be given to business units as the first line of defense within the context of enhancing risk culture. The business line engages in day-to-day risk management as a result of its routine business activities. Hence the business line should play a substantial role in embedding risk culture within a financial institution, by observing practices that are aligned with the risk culture of the organization. In particular, the risk culture is enhanced when the business line (as a risk taker) is *accountable* for prudent risk-taking.

Question 2 (areas for clarification)

- *Timing of implementation* – Presently, the FSB consultative document does not indicate when the guidelines will start to be used by supervisors during risk culture assessments. It would be useful to have clarity about the timeframe the FSB has planned for implementation of the guidance, which will help the industry and supervisors better prepare for such assessments.
- *Mechanisms to implement indicators* – A number of the provisions in the FSB Guidance require firms to establish 'mechanisms' to address the effectiveness of certain aspects of risk culture. In particular, under the *effective challenge* indicator (3.3.2), mechanisms are required to ensure that alternate views are expressed in practice and regular assessments

are made to evaluate openness to dissent. While practices should not be standardized or universalized since different approaches can be equally valid, it would be useful to have illustrative examples of types of mechanisms in this context.

- *Role of board of directors and role of senior management* – There is concern that in some cases the roles of the board seem to be placed equivalently with the roles of senior management, which in reality is not the case. The board generally provides oversight to ensure that management is fostering a strong risk culture, and that management establishes and monitors procedures. Such procedures cannot be effectively established and monitored by the board because of the relevant institutional knowledge needed to manage at the required level of detail. Such clarifications by the FSB Guidance would be helpful to avoid confusion about roles. A similar point is also reiterated under Question 5 below.

Question 3 *(further elaboration on the definitions of corporate culture, risk culture and sub-cultures within business lines, and on the relationship between them)*

- *Variability in culture* – Inevitably risk culture, which is a subset of corporate culture, varies across organizations and jurisdictions (just as corporate culture and sub-cultures within business lines would vary). Consequently, no two cultures are (or will be) the same. In this sense, the FSB guidance should avoid prescriptive approaches to the definition of what a risk culture should be. The 2009 IIF Report *Reform in the Financial Services Industry: Strengthening Practices for a More Stable System,* cited in the FSB Guidance provides a useful definition of risk culture in particular.[26] In our view, this definition captures the essence of risk culture and needs no further elaboration. However, it would be helpful to have clear guidance on a definition for corporate culture and also highlight that a healthy risk culture should be a part of a successful corporate culture.

Question 4 *(tools to assist supervisors in assessing risk culture)*

- *Avoid exhaustive list of tools* - There are a variety of processes and documentation developed by institutions for various important activities such as risk appetite setting, budgeting procedures and the like, as well as numerous reports and analysis that are regularly prepared and which could shed further light on institutions' risk culture. There is not an exhaustive list of tools, since each institution has a different approach (which is useful because it allows institutions to evolve to adopt more effective risk culture practices relevant to their business model). However, the evidence to determine the kind of culture in an institution is mostly available. The challenge for supervisors is the ability to connect the different indicators in a way that helps to identify the desired types of behavior and cultures in an institution.
- *Firms' internal assessments* – Firms regularly conduct self-assessments internally to understand the level of employee engagement and effective practices via internal surveys and other approaches. It would be helpful for supervisors to look at firms' internal efforts as a means to begin constructive discussions with boards and senior management about risk culture.
- *Supervisory culture* – The specific type of supervisory approach plays an important role in how risk cultures can be adequately assessed. In this sense, supervisory approaches that

[26] IIF, *Reform in the Financial Services Industry: Strengthening Practices for a More Stable System*, December 2009. pg. 31

are overly prescriptive, check-the-box or do not adequately consider materiality and proportionality and are primarily focused on compliance with mechanical procedures are not very meaningful in understanding risk culture. Supervisors should develop their own risk culture that is less compliance-driven and more holistic, looking at a variety of processes in institutions to understand their behavioral patterns.

Question 5 (expected supervisory responses to failures in tone from the top)

- *Clarification of failure*– There is no clear-cut response to this question because each supervisory response should depend on the kind and level of the specific failure. Failure by the board of directors in one context may require a recommendation to the board to enhance appropriate risk taking oversight, and in another context may require a more direct response. It would be useful however, to first conduct a risk culture assessment before a supervisory response to failure is provided.
- *Impacts of organizational changes on risk culture* – While risk culture takes a considerable amount of time to develop, it can deteriorate fairly quickly, particularly during organizational changes and restructurings such as mergers and acquisitions. To help avoid unintended consequences and risk culture breakdowns, some consideration could be given to the impacts of structural changes on risk culture.
- *Role of the board of directors* – The Board of directors plays the fundamental role of oversight of the firm. However, the Board does not manage the firm, which is precisely the role of senior management. In this context, it is essential that new standards and requirements relating to governance make the proper distinction between responsibilities of the Board and responsibilities of senior management. A blurred line in this area can create the risk of over-burdening the board with what otherwise are management responsibilities and limiting its ability to function effectively in playing its oversight role.

Question 6 (suggestions to improve supervisory engagement with financial institutions on risk culture)

- *Internal evaluations* – As indicated in the response to Question 4, firms frequently seek feedback from employees via surveys, discussions and other approaches to understand employee engagement and enablement. The industry would reiterate that it is a good place to begin constructive dialogue with institutions about risk culture.
- *A holistic approach* – Engagement with only one or two pockets of an institution will not provide the full picture of an institution's risk culture. A useful approach for supervisors would be to engage with individuals at all levels of an institution, especially since no one individual is responsible for risk culture and there might be varying views within an organization. An assessment that takes into account various levels and groups within an institution would be more informative. Furthermore, as noted above, while compliance is important, supervisors should avoid supervision based solely on compliance and box-ticking processes.
- *Constructive discussions* – The IIF report, *Restoring Confidence, Creating Resilience: An Industry Perspective on the Future of International Financial Regulation and the Search for Stability*, noted that effective supervision is a two-way street and that it is as much incumbent on the industry to make regulation and supervision work successfully as it is on

the official sector.[27] As a result, and as the Group of Thirty has noted it would be useful for supervisors to actively seek feedback on their performance from industry, including from board members.[28] The feedback could include comments on supervisors' approach to assessing institutions' risk culture. Furthermore, it is more effective to have supervisors with wider supervisory experience who can engage constructively with boards and senior management of firms. [29]

Indicators of a sound risk culture

Question 7 (additional risk culture indicators)

The identified indicators in the FSB Guidance are useful and appropriate. The industry would encourage the FSB to review the indicators over time (perhaps after two to three years) to assess their effectiveness and whether adjustments need to be made.

- *Education and training* - However, as a point of emphasis, evidence of training and education (listed in section 3.4.6) is a good indication of a firm's efforts to embed risk culture and useful practices. Education and training programs provided to all staff throughout the institution, shows a firm's commitment to fostering an environment where all employees can learn about risk culture and other useful attributes of the institution.

Question 8[30] (specific examples of good practices to support indicators)

- *A range of valid industry practices exist* - As indicated in the introduction of this section, institutions have a variety of specific approaches to risk culture as well as a wide range of practices to support prudent risk-taking. Such approaches and practices should always be looked at in the context of a specific firm, with a unique culture and business model. Hence, it would not be meaningful to provide a list of specific examples or practices, as they may not represent the entirety of useful and valid approaches.

[27] IIF, *Restoring Confidence, Creating Resilience: An Industry Perspective on the Future of International Financial Regulation and the Search for Stability,* July 2009. pg. 28
[28] Group of Thirty, *A New Paradigm: Financial Institution Boards and Supervisors,* October 2013. Pg. 30
[29] IIF, *Achieving Effective Supervision: An Industry Perspective,* July 2011. Pg. 26
[30] The industry would apply the same principle in Question 8 to **Questions 9 through 12**, underscoring that a list of examples, approaches, or indicators will not be useful since there is a wide range of practices within the industry that are equally valid.