PRMIA

THE PROFESSIONAL RISK MANAGERS' INTERNATIONAL ASSOCIATION

January 31, 2014

Mark Carney, Chairman - Financial Stability Board, and
Secretariat, Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel, Switzerland
Via email: fsb@bis.org

Re: Comments on Consultative Document ***"Increasing the Intensity and Effectiveness of Supervision - Guidance on Supervisory Interaction with Financial Institutions on Risk Culture"***
(http://www.financialstabilityboard.org/publications/c_131118.pdf)

Dear Chairman Carney and Secretariat to the Financial Stability Board:

On behalf of the Blue Ribbon Advisory Panel of the Professional Risk Managers' International Association (PRMIA) we are pleased to provide comments on the Financial Stability Board's (FSB's) consultative document issued on November 18, 2013 and its subsequent guidance of December 23, 2013 "*Guidance on Supervisory Interaction with Financial Institutions on Risk Culture - Questions for Public Consultation."*

(PRMIA's Blue Ribbon Advisory Panel is made up of a cross-section of senior risk professionals. Although their collective opinion has been greatly debated and appropriately vetted, it should not be accepted as the confirmed consensus of the Association's 90,000 members.)

Today, financial businesses interact in a global ecosystem where interconnections across sovereign jurisdictions provide an enormity of differing risk regimes in order to comply. To model and monitor this behavior will require cooperation by supervisors in the application of subjective judgments of good vs. bad behavior, or risky vs. appropriate behavior. Even judging the "tone-at-the-top" set by boards and their management has characteristics of subjectivity, requiring supervisors' judgments.

Given such subjectivity across many jurisdictional boundaries, what we, as risk professionals, have to offer is a direction toward a quantitative floor for boards and their management from which to allow supervisors to make consistent judgments. Here we take the FSB's lead in tying risk culture to risk appetite by suggesting a quantitative approach to risk appetite setting, and ultimately, tying those risk metrics to the enterprise risk management systems and framework of financial institutions.

In taking this approach, the Blue Ribbon Advisory Panel is hereby providing our perspective and observations based upon our collective experiences. Understanding a company's risk taking and risk mitigating conduct is a result of each individual's own behavior that collectively empowers group behavior, we will suggest what we term Key Risk Culture Indicators (KRCIs) for benchmarking such behavior.

The views of risk professionals about risk culture and its measurement exist between two extremes: measureable KRCIs can be identified, and a review of conduct and practices is insufficient to get complete insight into culture. If supervisors desire to assess risk culture as a part of their responsibilities, then there is concern amongst practitioners about the qualifications of supervisors to interpret any quantification of such culture deficiencies. There is also no mention of what a supervisor might do with this information. A better understanding of the intended uses of the review of risk culture would be very helpful in forming our comments.

If supervisors don’t understand how to use this review, then a “check-the-box” regulatory classification for risk culture would probably not be a helpful outcome.

The evaluation of company’s risk culture should be an iterative process since both the company’s and regulators’ understanding of risk culture evolves. A sound risk culture might appropriately be different for different financial institutions. Nevertheless, how this variance among corporate risk cultures is to be interpreted by supervisors should be somewhat consistent. Some are skeptical that an accurate risk culture assessment can be made after conversations with the board and senior management and whether the institution’s risk culture supports adherence to an agreed risk appetite. We agree with the starting point of the four principles of risk culture offered in the FSB’s Risk Paper and offer additional perspectives on more fully incorporating risk appetite into risk culture.

A review of practices may be insufficient to achieve an appropriate insight into a firm’s risk culture. The process of determining a firm’s risk appetite is an outward sign of the risk culture, but there may be many desirable risk cultures and not just one sound risk culture as suggested by the paper. In fact, the best risk culture may not be the “sound” or the “unsound” cultures that are inferred in the paper.

Our response is divided into a section on “*Foundational Elements of a Sound Risk Culture*” that recognizes the variability of cultures and the importance and linkages of risk governance, risk appetite and compensation. We also recognize that governance processes should be designed to support discernment of the changing business and economic environment to the adaptation of risk management practices. This can be accomplished by changing the underlying risk analytics of the risk appetite framework. In this section, we articulate and support a movement from a subjective evaluation to a more objective measurement of risk culture in order to achieve the FSB objective of “formally assessing risk culture at financial institutions.”

We are mindful that we can still differentiate cultures without risk measures, especially if we live inside of an organization. Furthermore, introducing measures of risk culture does not ensure that we will gravitate toward a strong risk culture over time. Nevertheless, we believe it is useful to articulate support of a more objective measurement.

This section is followed by the response to the “*Questions for Public Consultation”* dated 23 December 2013, where the four indicators of good risk culture put forward by the FSB are further expanded upon. The responses encourage development of Key Risk Culture Indicators (KRCIs) as measures of risk culture for each of the main key indicators described by the FSB:

- Tone from the top (4 subcategories)
- Accountability (3 subcategories)
- Effective Challenges (2 subcategories)
- Incentives (2 subcategories), and

In addition, we comment on other potential measures such as ethics, integrity, transparency, communication, adaptive or dynamic risk appetite, in addition to others.

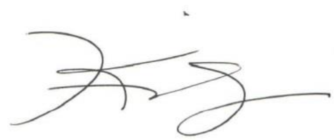
We believe that if a risk culture is successfully integrated into the fabric of a financial institution, then this will lead to a risk adjusted corporate culture that will benefit the entire financial ecosystem and, in turn, lead to stabilizing the global economy. However, it will take time, probably a generation, to indoctrinate staff to the new order of risk-adjusted performance and incentives, both within supervisor ranks and at financial institutions.

We look forward to developing a comprehensive relationship with the Financial Stability Board, seeking to become a cooperative collaborator and confidential liaison in representing the risk profession. As part of our education and accreditation mission, PRMIA has issued its global Professional Risk Manager (PRM™) certification to individual practitioners and regulators throughout the world. We will continue this effort while embracing new ideas about risk culture into the curriculum.

Respectfully submitted,

Blue Ribbon Advisory Panel* (BRP) of the Professional Risk Managers' International Association (PRMIA)

Kevin M. Cuff, Executive Director, PRMIA



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The Professional Risk Managers' International Association (PRMIA) is a non-profit professional risk management association. PRMIA is active in nearly every major financial center worldwide and provides an extensive and engaged network of risk professionals, with more than 90,000 members around the world.

Foundational Elements of a Sound Risk Culture

Background

Risk cultures vary across financial institutions, and sub-cultures may exist within institutions, but there are certain fundamental elements that contribute to (but do not determine) the evolution and promotion of sound risk cultures. Such effective elements are strong risk governance and risk appetite frameworks, as well as compensation practices that encourage appropriate risk-taking behavior. These important foundational elements have been further elaborated by the Financial Stability Board (FSB) in previous consultative papers. Financial institutions, in particular systemically important financial institutions (SIFIs), are expected to meet supervisory expectations in these areas.

In this later regard, earlier progress reports on Increasing the Intensity and Effectiveness of Supervisors had the FSB's Supervisory Intensity and Effectiveness (SIE) Group directing supervisors to further explore ways to formally assess risk culture, particularly at global SIFI's (G-SIFIs). For example, metrics provided included audit findings that had not been closed, results of employee surveys, and others. The SIE suggested that these and other metrics could allow conclusions about culture to be reached on an ongoing basis prior to major issues arising. The SIE concluded that supervisors should also expect financial institutions to be proactive in this regard.

The SIE further noted that such efforts as risk culture assessments require seasoned judgment by supervisors and that this may be seen as stepping into areas that typically are the remit of the firm's management. For supervisors themselves it reflects the significant externalities that exist with SIFIs, thereby requiring more robust succession planning and appointment processes for key positions, particularly leaders of key control functions.

Further, the FSB is supporting 'outcomes-based supervision' by proactively assessing the decisions of the financial institution based on its strategic vision, business model and risk appetite framework. As stated by the FSB, regulatory supervision is 'not only about ensuring compliance with the rules but also with the spirit' of those rules. Paramount in this supervisory approach is an understanding, by both the financial institution and the supervisor of the institution's risk culture (reference footnote 4 of the consultative paper), as noted below:

> "…the norms of behavior for individuals and groups within an organization that determine the collective ability to identify and understand, openly discuss and act on the organization's current and future risk".

We, as risk practitioners steeped in the science of risk metrics and risk management, see determinants of a risk culture being based on "…the norms of behavior..." as a predominately subjective process. However, we see determinants of a risk culture based on the "…ability to identify…current and future risk" as within our scope to opine on professionally. We, therefore, encourage supervisors to establish, with the financial service industry's guidance, their ability to 'grade' risk culture by:

1. Establishing a quantitative floor upon which to make correlations of subjective framework statements to the risk metrics of individual institutions, and
2. Benchmarking such metrics industry-wide, starting with the FSB's twenty-nine (29) already identified global systemically important banks (G-SIBs) and 9 global systemically important insurers (G-SIIs)

Our starting point is the earlier Risk Appetite consultative paper, now finalized, that defines both framework level statements of risk appetite and associated quantitative metrics. From the paper:

Risk appetite framework (RAF):	The overall approach, including policies, processes, controls, and systems through which risk appetite is established, communicated, and monitored. It includes a risk appetite statement, risk limits, and an outline of the roles and responsibilities of those overseeing the implementation and monitoring of the RAF. The RAF should consider material risks to the financial institution, as well as to the institution's reputation vis-à-vis policyholders, depositors, investors and customers. The RAF aligns with the institution's strategy.
Risk appetite statement:	The articulation in written form of the aggregate level and types of risk that a financial institution is willing to accept, or to avoid, in order to achieve its business objectives. It includes qualitative statements as well as quantitative measures expressed relative to earnings, capital, risk measures, liquidity and other relevant measures as appropriate. It should also address more difficult to quantify risks such as reputation and conduct risks as well as money laundering and unethical practices.
Risk capacity:	The maximum level of risk the financial institution can assume given its current level of resources before breaching constraints determined by regulatory capital and liquidity needs, the operational environment (e.g. technical infrastructure, risk management capabilities, expertise) and obligations, also from a conduct perspective, to depositors, policyholders, shareholders, fixed income investors, as well as other customers and stakeholders.
Risk appetite:	The aggregate level and types of risk a financial institution is willing to assume within its risk capacity to achieve its strategic objectives and business plan.
Risk limits:	Quantitative measures based on forward looking assumptions that allocate the financial institution's aggregate risk appetite statement (e.g. measure of loss or negative events) to business lines, legal entities as relevant, specific risk categories, concentrations, and as appropriate, other levels.

A further starting point is the comments received on the Risk Appetite paper from industry practitioners, trade associations and academics. In this regard, responses submitted from Blue Ribbon Panel members associated with such organizations informed this Risk Culture paper response, which we note below:

- Deloitte LLP points out that 'risk triggers' are not defined and further definition would help supervisors to understand how risk limits have been calibrated and whether or not there would be sufficient time for mitigating actions to take effect before risk appetite were breached.

- The University of Leeds notes that the absence of a common unit of measurement applied to risk appetite means that financial firms, their investors, and supervisors have no readily accessible, comparable and actionable set of measurement-based metrics through which they can determine how much risk a firm has taken-on on an absolute basis or in comparison to others or whether it is operating within the risk appetite limits approved by their boards of directors. They propose such a measure.

- The American Council of Life Insurers (ACLI) notes that while the Risk Appetite paper primarily applies to SIFIs it is to be applied to non-bank financial institutions as well and, as such, should recognize the principle of proportionality to reflect firm-specific organizations and business models.

- The CRO Council and the CRO Forum also suggest that risk appetites should fit the business purpose of the firm, within the boundaries of its capacity, and in line with its desire for growth. The paper should enable supervisors to understand the risk appetites, but avoid the imposition of excessive caution and risk avoidance. Providing additional capital as a tool of risk management should be weighed against the effectiveness of internal risk management frameworks and that both qualitative as well as quantitative measures should be applied in performing risk appetite supervisory reviews.

In addition, we were further informed by:

- "Cultivating a Risk Intelligent Culture" authored by Deloitte LLP
- "All on the Same Train, but Heading in Different Directions - Risk attitudes among insurance company management and implications for forming a Risk Culture authored by Underwood, et al.
- "Risk Culture in Financial Organizations" authored by the London School of Economics
- The recent US's Volcker Rule.

Introduction

Financial products, financial institutions and their associated risk management techniques have become complex. More precisely, complexity has been used as a means by some for rationalizing opacity in the financial system. Major initiatives sponsored by regulators and industry members have made great strides in bringing more transparency to financial transactions and financial actors. This is particularly apparent in the "shadow banking system" where regulation of hedge funds and the over-the-counter derivatives markets are now under increasing regulatory supervision. Even the creation of the new category of supervised entities, SIFIs, is a further recognition of the need for enhanced transparency through increased surveillance and reporting.

The financial services industry and, in fact, the modern financial institution, is a sub-culture of society that did not have the benefit of founding statesmen to set its culture down in documents or pass on through established institutions. The risk culture in the financial industry that was originally practiced was one that had the founders' watchful eye on their own capital which was always at risk. It was a model that would prove to be not scalable. Financial organizations were small enough to see bad behavior of protégés and correct it in real time before the young were given the privileges that come with more responsibility.

Today's financial institutions are large, complex global organizations. Risk management has become institutionalized and impersonal, methodically structured and mathematically calculated. However, the core methodologies of risk management are at times imprecise, especially during times of market stress, when controlling a business on a risk adjusted performance basis is most needed.

The FSB is directing us towards a risk culture that rightly calls for a linkage between risk culture and risk appetite. We, therefore, must metricize risk appetite and get the risk measurement systems right, or financial executives will be battling the 'show-me-where-the compliance-manual-says' or 'show-me-the board-minutes-where-it-said' argument with regulators for years to come.

Our public comment will attempt to provide a path for regulators and the financial industry toward matching the risk metrics of the enterprise with its risk culture. This can be accomplished through aggregating metrics found in the risk appetite and risk limit definitions that are articulated in the risk appetite statement. Thus, the risk appetite framework, already tied to the risk metrics of the enterprise, will permit setting quantitative expectations against which risk culture can be judged.

Understanding of Consultative Paper

The FSB's consultative paper on Risk Culture ties the risk culture of a financial institution to the tone set from the top. The FSB also suggests we should look beyond such behavioral goals to further tying risk culture to the firm's statements of risk appetite and, in turn, to its foundation in the enterprises' risk management systems and methodologies.

If a financial institution's staff does not receive clear measureable goals from those who set the tone at the top, then we will create an opaque foundational element of risk management. The organization will benefit from linking the statement of risk culture to the statement of risk appetite, itself set at the top of the firm and which is anchored in the measureable aspects of the firm's risk management framework. In complex businesses in any industry, especially as businesses become more global, senior management and the board cannot simply walk the shop floor or 'feel' the risk of their own capital being exposed to market trends. They must rely on a set of metrics. They must trust those metrics and they must have a feel for those metrics when stress situations warrant experienced judgments and intuition to transcend metrics. Without measurement we cannot manage an enterprise of size, complexity and global reach. In the financial industry without the board's and its management's understanding of the strengths and weaknesses of risk and performance measurement systems, they will not be able to make adjustments to business strategies and risk management practices that will be required in stress situations.

The FSB's efforts to reduce risk in the global financial system have concentrated initially on SIFIs. The FSB's oversight aims are to deliver pre-emptive, rather than reactive supervision, proactively assessing the decisions of these financial institutions based on their own strategic vision, business models and risk appetite frameworks.

The FSB's supervision regime, while assuring compliance with rules set down by local financial supervisors, should move toward assuring adherence to the spirit of the rules. At the core of this supervisory approach is an understanding of the institution's risk culture, in particular whether it supports appropriate behaviors and judgments within a strong risk governance framework.

In order to achieve this outcome, supervisory interaction with boards are to be stepped up, to engage in high-level skeptical 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.

Current State

Virtually all large financial institutions have the 'outward trappings' of a risk culture - they generally have well documented models, governance structures and processes which have been subjected to audit and regulator inspection.

In spite of outward signs of 'approved' risk management structures, some financial institutions have failed to adequately manage risk and have met with 'extinction' events. Part of this is due to bad luck. But part is also due to the fact that enterprise and departmental risk management systems, methodologies and frameworks and incentive compensation schemes are not complete without a well-defined risk culture. Unfortunately, risk culture is not only difficult to define but also difficult to change. Architects of the new risk culture for finance usually focus first on compliance and then on compensation. Other candidates for risk culture adjustment are tone from the top, board director risk qualifications, strengthening hiring and training programs, and installing formal mentoring programs. Still others focus on psychological testing and view the enterprise as an ecosystem of social mores, values and belief systems that can be modified over time.

All of these components of risk culture are probably necessary components, but none by itself is sufficient. Until management and boards become more risk aware, both technically and attitudinally, there is no amount of risk management systems or regulations that will overcome the negative effects of a poor risk culture.

What is Culture?

Culture is a product of shared beliefs that gets played out every day in one's daily life, whether the private one or the corporate one. Some would even say the optimal state of a culture is that individuals in a company share beliefs common to both their corporate lives and their personal lives. That culture cannot be created overnight is obvious; it's the result of a consistent, multi-year, open exchange of views, healthy skepticism and questioning of widely-held beliefs. It gets played out in a parent shaping a child's national or ethnic culture, in a coach or dance instructor teaching discipline, in a religious leader instilling moral and ethical values, and in a mentor shaping an apprentice's corporate and risk culture. In a financial institution we would like to believe we can see a 'risk adjusted corporate culture' in our industry's future.

In enduring corporate cultures we see a recognition of common beliefs of one's private and business life. It starts at the recruiting level, finding people who will 'fit' into the culture of the firm, moves on through the training programs, gets codified in performance appraisals, and finally, gets melded at a one-to-one level with a mentor system that passes the culture from one generation to the next.

What skews a firm's risk culture is a belief by a few that winning is all that matters and that greed has no counterpoint in fear, that if one gets to the finish line, the bonus pool day, by any means one can take the money off the table and never look back.

Partnerships of like-minded management and boards exercise risk management the way anyone risking their own capital would. The partners, being in close proximity, would caucus continuously and decide the market view for the period under discussion, the creditworthiness of clients, and which trading desk would be given the partnership's money for investing and trading.

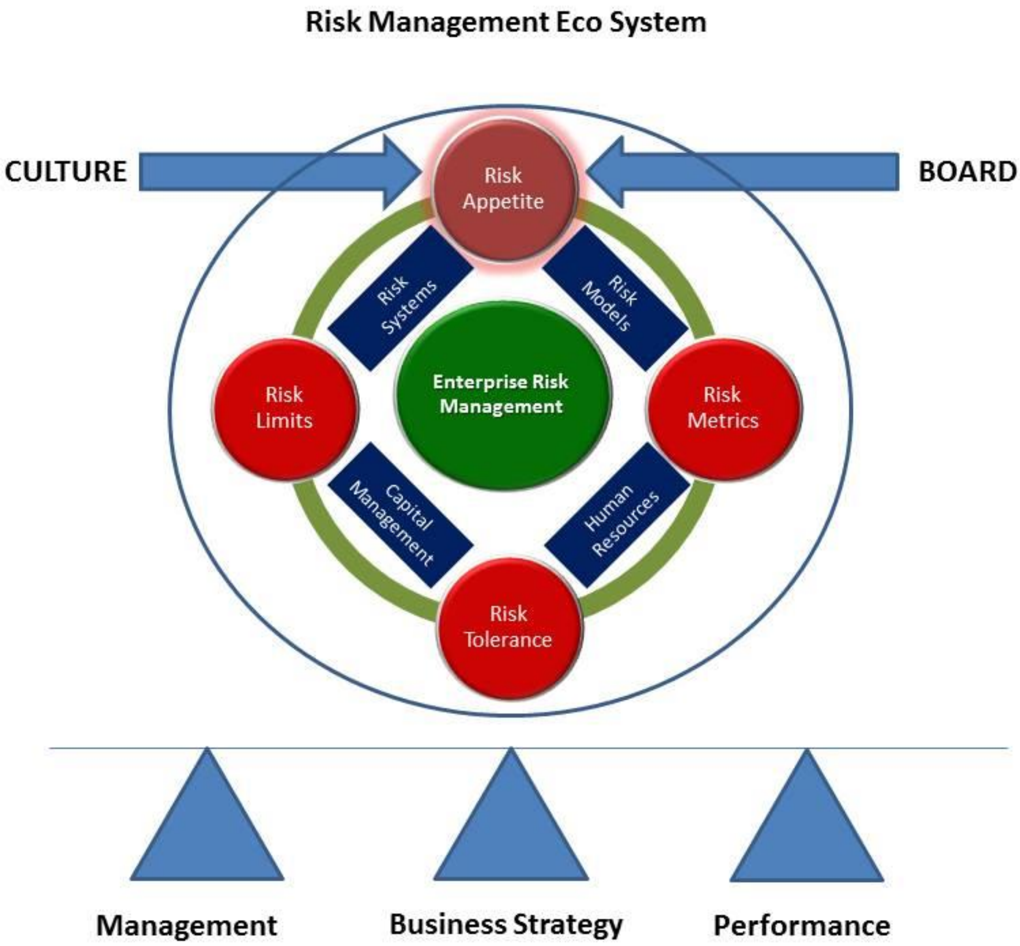
There was a feeling of closeness in the firms prior to financial conglomeration and the rise of global banks. There was a sense of intimacy felt both culturally and physically. Personal mentoring was easier in this environment. Culture was transmitted almost effortlessly. In seeing a transgression it could easily be remedied. Then it began to change, slowly at first, then more rapidly through a volatile mix of investment partnerships, banks and savings and loans pushed by regulation out of its long standing legally permitted monopolistic pricing and exclusive territorial or market privileges into an increasingly competitive business model. Globalization removed the intimacy in which culture is best transmitted. Partners and private investors who took their own capital out of the business through a public sale of its shares removed the tie to their best risk control, putting their own money on the line.

Fixing the Baseline

The culture of the global financial industry is left to be constructed, not only in the context of a very complex risk management regime, but also in a similarly complex information technology and communication environment. The prevalent short term performance and incentive culture that has characterized much of finance in the last half century needs to be muted by longer-term financial goals and a technology engineering culture that is required to fix our plumbing and factory, improve our risk models, rethink our performance and incentive compensation systems and, thereby, collectively risk adjust the financial system within the context of the Risk Management Eco System (see diagram on next page). It is the expectation of regulators, the public at-large, and industry members alike, that a fundamental cultural change is needed to get us through to the next stage in the evolution of our banking, capital and contract markets.

Toward this cultural objective we, as the Blue Ribbon Advisory Panel, have embraced the setting of standards of conduct and best practice for the risk profession. We intend that such a code of conduct will be shared with others. Our intention as the current generation of risk professionals is to evolve such standards of professional risk practices and to demonstrate to regulators and the public alike that our next generation of risk professionals is risk aware, proficient and risk sensitive, embracing such practices and the high ethical values we all aspire to in the best interest of society.

In order to show the interaction of risk culture with the important linkages of a risk appetite framework (RAF) including risk appetite, limits, metrics and tolerance to the enterprise risk management framework we have included a graphic below depicting these components and interrelationships.



Financial Institutions on Risk Culture
Questions for Public Consultation

On 18 November 2013, the Financial Stability Board (FSB) published the consultative document *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture* (Guidance). This addendum sets out some questions to consider in preparing the submissions on the consultative document.

General questions

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

Yes, in general what is needed is how to use risk metrics to tie two soft concepts, risk culture and risk appetite together so some objectivity can be brought to what could be endless debates on subjective text in both framework statements.

Another area is the establishment of a standard code of conduct and best practices, not unlike those for actuaries or public accountants. This effort would be best organized through the FSB's bully pulpit to draw in a group of risk accreditation organizations, risk and allied trade associations, practitioners and academics.

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

More objectivity is needed, especially to support what will be subjective determinations of what constitutes "good" or "bad" risk cultures. To this end the FSB would benefit from articulating support of a movement from a purely subjective evaluation to a combination of key risk culture indicators (KRCIs) that can be mapped to more objective measures of risk culture in order to achieve the FSB's objective of "formally assessing risk culture at financial institutions." This can be accomplished by establishing certain KRCIs that can be mapped to the metrics of key risk indicators (KRIs) many of which are discussed in the FSB's Risk Appetite paper. With these metrics we can have a set of quantifiable benchmarks that 'different risk cultures" can evolve around within reasonable variances set by regulators. When variances are breached, supervisors can inquire further.

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?*

Yes, the guidance would benefit from further elaboration to tie culture to the operational components of financial institutions. For example there are many comments by supervisors on the business silo structure of financial institutions that prevent the coherent and standardized aggregation of risk data. The most notable is the recent BIS paper "Principles for Effective Risk

Data Aggregation and Risk Reporting" and its follow-on progress report "Progress in Adopting the Principles for Effective Risk Data Aggregation and Risk Reporting."

Encouraging the further elaboration of a corporate (or enterprise) risk culture at the business unit level where cooperation and sharing is fostered and where, for example, shared enterprise systems budgets are part of the culture would begin the long sought-after reengineering of enterprise risk systems.

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

A prerequisite for regulators to have a meaningful discussion around the underlying causes of behavioral weaknesses would be the continual training of Supervisors' staffs that perform assessments.

In addition, Supervisors could benefit from the following tools:

- Risk appetite statements that are "hardened" and mapped to risk metrics and, in turn, to the risk culture framework. For example the number of:
    - individuals in compliance with mandatory training requirements
    - divisional/departmental managers with risk weighted performance metrics
    - trading limit breaches, by desk, by counterparty
    - compliance breaches
    - VaR exceptions by portfolio, by trading desk

- A code of conduct and best practices for the risk profession
- Inter-industry-regulator training programs, for CROs and senior supervisors

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?*

In order to understand the nature of the potential cultural failure, the supervisor may first contact the board to understand the incident or may conduct or ask for an inquiry and investigation to establish a baseline understanding of the situation and its implications. Such a discussion should best be carried out by highly experienced supervisors. There will likely be some situations where both boards and regulators will benefit by direct interaction however requests to the board should be conducted with careful consideration.

We would expect that supervisory responses to identified cultural failures may vary depending on the nature and severity of the cultural failure and the impact to the financial institution, its customers, counterparties, investors and the broader financial system. For lower severity incidents, the supervisor could request training or changes in procedures to provide clarity and emphasis to the importance of risk culture. Alternatively for high severity incidents, the supervisory response could include an enforcement action or request to change board or management personnel.

With respect to assessing board risk committee directors, boards and supervisors may consider the Qualified Risk Director guidance proposed by the Directors and Chief Risk Officers Group. http://www.thegovernancefund.com/DCRO/

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?*

Share educational and training sessions with practitioners conducted by impartial and knowledgeable risk, ethics and behavioral professionals.

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?*

It is our view that, while sufficient, it is not complete, including the idea that more work needs to be done on key risk culture indicators (KRCIs). The challenge for the FSB is to formalize a process which collects input from practitioners and academics to develop key risk indicators (KRIs) that can be measures of risk culture for each of the four main key indicators and their sub-categories. We have attempted to describe these indicators in more detail below, using the numerical sections identified in the consultative paper. Where appropriate we have suggested approaches to further refine the meanings of these indicators as a first step in the process of formalizing KRCI metrics. It is our intention that what follows below is but a preliminary view of our response.

3.1 **Tone from the top** is present in the key managers and in their behavior. It is articulated in an expression of management's strategic plans carried through into corporate culture statements and further into statements about risk culture. It is demonstrated in words and deeds. The best example of an expression of risk culture is a statement that melds risk culture with corporate culture. For example such a statement could be:

> ***"Our firm strives to achieve a fair risk adjusted return for our shareholders commensurate with the competitive environment and the financial eco-system we thrive in while recognizing that we must be constantly vigilant that our firm's risk, and performance culture must contribute toward society's benefit."***

- 3.11 – 3.15 The attribute of **Leading by example** encourages the board and management to advance competitive leadership skills of individuals as a desired trait, both within the normal contentious hierarchical structures of financial institutions in advancing individual careers and in advancing external competitive outcomes. At the same time, boards and management must encourage attention to the details as hands-on management and informed boards are the best guardians of proper risk management. In the end, when the dashboards are all showing red indicators and all the risk metrics are indicating that stress is building up in the financial system, it is only knowledge and experience that inform the judgments of the board and management as to what course of action to take to mitigate risk.

- 3.16 – 3.18 For supervisors to assure that the financial institution's board and management have an ability of **assessing espoused values,** it should require every individual to be aware of expectations of appropriate conduct and practice. Supervisors should be able to obtain a redacted set of these documents and search the data for occurrence of key words found in the risk culture statement and corporate strategy statements, among other search criteria developed by supervisors in benchmarking risk culture effectiveness across multiple firms.

- 3.19 – 3.1.11 **Ensuring common understanding and awareness of risk** is best accomplished through such devices as mentoring of engaged operating management, participating in divisional/departmental performance reviews and reviewing indicators of promptness of response to observed weaknesses.

- 3.1.12 – 3.1.13 One of the most important determinates of an adaptive risk culture is **learning from risk culture failures.** The tone here is set by the board and counsel, neither constituents condoning finessing of such events. For example, a mistake that will shortly be corrected should be reported as a potential incident that would cause unwanted risk to be accepted and/or losses to be incurred. A loss that would not be material in an accounting sense, nevertheless, should be reported into the internal risk incident logs and to any external reporting databases that log such "near misses" or actual losses. This later point is to reinforce the tone-from-the top that such reporting contributes to the risk management eco-system by helping all financial institutions understand risk so that collectively they can contribute to stabilizing the global economy.

3.2 **Accountability** is the acceptance of individual responsibility for the collective ownership of one's own financial institution's risky behaviors and risk mitigation practices. It is also the collective responsibility of ownership of the individual institution's contribution to systemic risk beyond its own business and regulatory borders.

- 3.2.1 – 3.2.3 **Ownership of risk** in a complex financial institution must be considered in context of the current state of silo business structures, separate risk reporting lines, and improvements still necessary for sharing risk information across the enterprise, let alone across multiple enterprises. Owning up to the risk beyond norms is as much an understanding of the specific compliance issues breached as it is breaching risk limits. Encouraging individual "risk heroes" is a first line of defense in ownership of risk. In such a risk culture, meetings that formerly highlighted revenue enhancement or cost reduction accomplishments would have an agenda item of risk mitigation as well.

- 3.2.4 – 3.2.7 The **escalation process** of a risk aware institution requires making one's immediate direct report aware of a potential or actual breach of a compliance prohibition or a risk limit. It must be followed up by reporting to a risk management system monitored by the risk management group and the compliance function. Such a system would have pre-determined parameters of escalation whether to involve internal and outside counsel, internal or external auditors, and whether to escalate it further to the risk committee of the board.

- 3.2.8 – 3.2.9 **Enforcement** demands consequences for risky behavior that goes beyond the accepted norms of the institution and its supervisor. However, without indicating clearly and objectively the key risk culture indicators that have been breached, the financial institution will be put at legal risk when taking disciplinary or remedial action. It is, therefore, imperative that breaches of risk culture are formalized through association of KRCIs with KRIs such as VaR breaches, trading limit breaches, and expense account overreach. Most importantly, performance appraisals that consider risk culture breaches should have objective metrics to base such appraisals on, including the associated compensation awards.

3.3 Organizations that demonstrate an **effective challenge** culture are constantly promoting risk awareness. While transparency and effective communication may be thought of as a key indicator of a strong risk culture, these indicators rely on the quality of the data that their computerized risk management systems produce. No amount of transparency will cover for bad data. No amount of communicating bad data will lead to improved behavior.

- 3.3.1 – 3.3.2 Policies and behavior that is **open to dissent** are set by management's encouragement of alternative thinking, naysayers being allowed to vent, contrarian views, etc. It is most effective when individuals in groups are encouraged to "speak out" by the most senior person setting the agenda for a meeting. The mere fact that an agenda item for such "dissent" is listed is a device that suggests management's risk culture is effective.

- 3.3.3 – 3.3.5 The **stature of risk management** can only be reinforced by the stature of the individuals hired to perform risk and compliance functions in a firm. As with any "C level" member of management, the CRO must have executive presence, appropriate credentials, and be able to articulate the firm's risk culture persuasively and passionately. The CRO and the chief compliance officer (CCO), who is now more typically drawn from the ranks of the legal profession, is itself a profession of stature and discipline. When they operate as a team, they reinforce the appropriate stature of the risk discipline. The CRO, and increasingly the CCO, should be afforded the externalities of such, for example: attendance at stakeholder meetings; significant presence at industry events; and proximity and access to the CEO and board. Finally, the stature of the risk management discipline is to be judged by the team the CRO and CCO recruit, train and discipline to carry out the difficult task of being the policemen of risky behavior.

3.4 Incentives, both for compensation and advancement are tied to motivating behavior consistent with the corporate and risk culture of the institution. It starts at the recruitment and hiring stage, advances through the training and mentoring stage and proceeds, finally, to the assumption of responsibilities for the risk adjusted performance of the institution. The risk management and compliance functions should have a formal mechanism for dialoging with the human resource function so that such programs are reinforced with a risk awareness culture at all stages.

- 3.4.1 – 3.4.3 Line management is given the ultimate responsibility for bringing revenue generators and next generation management through the process of rewarding through **remuneration and performance** recognition for successes; disciplining those for failures; and mentoring the anointed "stars" for leadership positions. Standard measures of remuneration and performance are critical here to encourage team-building, "for the firm's" risk adjusted corporate culture.

- 3.4.4 – 3.4.6 The hierarchical structure of most large financial institutions encourages a contentious process for **talent development and succession planning** where winners and losers are apparent. Interaction of line risk management and compliance officers must be vigilant in policing both the winners, who could by their success be encouraged to take on more risk, and the losers who may take out their personal losses in risky behavior.

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

See 7 above. In addition:

- Rotate new hires through management training programs across a broad scope of the company's business as it is critical to embedding risk awareness and a risk sense into the risk culture of the enterprise.
- Promote from within. Risk awareness and risk sense is prevalent in personnel in organizations whose C-suite members have been promoted from the factory floor and from the customer-facing sides of the business. They had previously run businesses that were driven by both performance metrics and risk metrics. From this experience they refine their understanding of the risk metrics that can be relied upon to run the business vs. the kind that is there to appease regulators. In the end they substitute their knowledge, experience and judgment when the metrics and their intuition are not in synch. They manage risk through informed intuition in those instances of stress and unaccounted for scenarios.
- Share a common risk management vocabulary.
- Refine risk performance metrics to reflect changes in business strategy, risk appetite, and tolerance.
- Reposition individuals to reflect changes to business strategy and priorities.

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 best risk management culture may not be the "sound" or "unsound" cultures but a fully "adaptive" culture suited to the business and economic environment at the time. The key to articulating such an adaptive risk culture is to modulate the risk appetite of an organization through risk adjusting the metrics that underpin the enterprise's risk management and performance metrics. The risk appetite statements can then be adapted quarter by quarter, annually, etc. as are the performance metrics tied to the corporate culture and strategic statements of the enterprise overall. The articulation of risk culture can be both qualitatively and behaviorally stated, but have its roots in metrics such as those described in the Risk Appetite paper and in the Risk Management Eco-system diagram. As an example of such objective measures no loss or breach of limits beyond a variance of y% should go unreported in any one day, any breach of z% in any one week, etc.

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?*

The FSB should encourage the industry to develop a Standard of Conduct and Best Practice (SCP) for the different roles of the board, senior management and other control functions at both the enterprise level and the individual risk professional level, for both the compliance function and the risk function. Each shall be specific to the roles of: the board 'defining'; the senior management 'implementing'; and the risk and compliance functions 'monitoring'.

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

What has not yet been accomplished is tying risk culture to the key performance and risk metrics of a firm in order to make the linkage between risk culture and risk adjusted performance more tangible. This could be accomplished by developing and tying KRCIs to both KPIs and KRIs. The FSB should encourage academic and practitioner efforts to demonstrate a measurable linkage between a superior risk culture and risk adjusted performance.

The industry and regulators will benefit from having a measurable set of metrics of risk culture (KRCIs) that can be developed over time, with links to both KRIs and KPIs, and which can be benchmarked across financial institutions.

Thereafter, it can be moved from the more granular level to the more aggregated. Initially, focus could be on the main four key indicator levels (described in Section 7), subsequently move toward the 11 subcategory levels (also described in Section 7), and ultimately toward individual indicator levels.

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".

Strong

- Fair dealings with clients comes first
- If it smells wrong in any environment, business or otherwise, it is wrong!
- Ethics before process
- Responsibility toward the critical nature of being part of a strong link in a chain of interconnected financial institutions

Weak

- A culture that does not permit its personnel to be comfortable looking at themselves "in the mirror"
- An ethos of privilege and wealth
- The lack of understanding of the critical nature of being part of a weak link in a chain of interconnected financial institutions that can threaten the financial stability of the global economy