FINANCIAL STABILITY BOARD

Guidance on Supervisory Interaction with Financial Institutions on Risk Culture

A Framework for Assessing Risk Culture

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Table of Contents

Page

Background

Increasing the intensity and effectiveness of supervision is a key component of the Financial Stability Board's (FSB's) efforts to reduce the moral hazard posed by systemically important financial institutions (the SIFI Framework), along with requiring added capital loss absorbency and facilitating the orderly resolution of financial institutions.[1] The FSB issued its first recommendations for enhanced supervision of financial institutions, in particular SIFIs, in October 2010, which underscored the key preconditions for effective supervision, including the need for (i) strong and unambiguous mandates; (ii) independence to act; (iii) sufficient quality and quantity of resources; and (iv) supervisors having a full suite of powers to execute on their mandate.[2] Subsequent recommendations in 2011 and 2012 strengthened the supervisory expectations for financial institutions' risk governance, internal controls and risk management functions, as well as risk data aggregation and risk reporting capabilities.[3] A number of these recommendations have been implemented and, collectively, have raised the bar for both supervisors and SIFIs.

This paper takes forward the recommendation set out in the November 2012 progress report for supervisors to explore ways to assess risk culture at financial institutions, particularly at SIFIs.[4] The paper draws on the collective experience and efforts of supervisory and regulatory authorities across the FSB membership and insights garnered from market participants through roundtables and bilateral discussions.[5]

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1 See FSB, *Reducing the moral hazard posed by systemically important financial institutions*, October 2010 (http://www.financialstabilityboard.org/publications/r_101111a.pdf).

2 See FSB, *Intensity and Effectiveness of SIFI Supervision – Recommendations for enhanced supervision*, November 2010 (http://www.financialstabilityboard.org/publications/r_101101.pdf).

3 See FSB, *Intensity and Effectiveness of SIFI Supervision – Progress report on implementing the recommendations on enhanced supervision*, November 2011 http://www.financialstabilityboard.org/publications/r_111104ee.pdf); and FSB, *Intensity and Effectiveness of SIFI Supervision – Progress Report to the G20 Ministers and Governors,* November 2012 http://www.financialstabilityboard.org/publications/r_121031ab.pdf). The expectation is that institutions should have 'strong' and not merely 'good' risk management, and that high standards of risk management should be fully integrated into an institution's culture and compensation practices.

4 See FSB, *Intensity and Effectiveness of SIFI Supervision – Progress Report to the G20 Ministers and Governors,* November 2012, pages 3-4 (http://www.financialstabilityboard.org/publications/r_121031ab.pdf).

5 The FSB Supervisory Intensity and Effectiveness (SIE) group held a roundtable on risk culture with board members, risk committee chairs and chief risk officers of banks and insurers and had discussions with the Group of Thirty (which in 2013 published the paper *A New Paradigm: Financial Institution Boards and Supervisors*), KPMG, and McKinsey & Company, Tapestry on their respective work in this area. In addition, members of the SIE participated in the July 2013 IIF Symposium on Supervision which focused on risk culture at financial institutions. Selected research was also considered such as that relating to safety culture.

Introduction

Increasing the intensity and effectiveness of supervision is a key pillar of the FSB's efforts to reduce the risks posed by systemically important financial institutions (SIFIs). A more intense and effective approach to oversight aims to deliver pre-emptive, rather than reactive, outcomes-based supervision. An anticipatory and strategic approach to supervision rests, among other things, on the ability to engage in high-level sceptical conversations with the board and senior management on the financial institution's risk appetite framework, and whether the institution's risk culture supports adherence to the board-approved risk appetite.

Culture can be a very complex issue as it involves behaviours and attitudes. But efforts should be made by financial institutions and by supervisors to understand an institution's culture and how it affects safety and soundness. While various definitions of culture exist, supervisors are focusing on the institution's norms, attitudes and behaviours related to risk awareness, risk taking and risk management, or the institution's risk culture.[6]

Weaknesses in risk culture are often considered a root cause of the global financial crisis, headline risk and compliance events. A financial institution's risk culture plays an important role in influencing the actions and decisions taken by individuals within the institution and in shaping the institution's attitude toward its stakeholders, including its supervisors.

A *sound* risk culture consistently supports appropriate risk awareness, behaviours and judgements about risk-taking within a strong risk governance framework. A sound risk culture bolsters effective risk management, promotes sound risk-taking, and ensures that emerging risks or risk-taking activities beyond the institution's risk appetite are recognised, assessed, escalated and addressed in a timely manner.

A sound risk culture should emphasise throughout the institution the importance of ensuring that: (i) an appropriate risk-reward balance consistent with the institution's risk appetite is achieved when taking on risks; (ii) an effective system of controls commensurate with the scale and complexity of the financial institution is properly put in place; (iii) the quality of risk models, data accuracy, capability of available tools to accurately measure risks, and justifications for risk taking can be challenged, and (iv) all limit breaches, deviations from established policies, and operational incidents are thoroughly followed up with proportionate disciplinary actions when necessary.

Risk culture, as well as corporate culture, evolves over time in relation to the events that affect the institution's history (such as mergers and acquisitions) and to the external context within which the institution operates. Sub-cultures within institutions may exist depending on the different contexts within which parts of the institution operate. However sub-cultures should adhere to the high-level values and elements that support the institution's overall risk culture.

First and foremost, it should be expected that employees in all parts of the institution conduct business in a legal and ethical manner. An environment that promotes integrity should be created across the institution as a whole, including focusing on fair outcomes for customers.

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[6] Various definitions of risk culture are available. The 2009 International Institute of Finance report "*Reform in the financial services industry: Strengthening Practices for a More Stable System*" defines risk culture as the norms of behaviour for individuals and groups within an organisation that determine the collective ability to identify and understand, openly discuss and act on the organisations current and future risk. See also Power M., S. Ashby and T. Palermo, *Risk culture in financial organizations,* London School of Economics and Political Science, 2013 (http://www.lse.ac.uk/researchAndExpertise/units/CARR/pdf/Final-Risk-Culture-Report.pdf).

Supervisors should consider whether an institution's risk culture is appropriate for the scale, complexity, and nature of its business and based on sound, articulated values which are carefully managed by the leadership of the financial institution. In this regard, supervisors should set expectations for the board to oversee management's role in fostering and maintaining a sound risk culture. This requires supervisors to effectively articulate these expectations to the board and senior management and ensure ongoing follow-up on whether these expectations are being met.

This paper identifies some foundational elements that contribute to the promotion of a sound risk culture within a financial institution (see Section 1), and will evolve as more experience is gained and additional insights are garnered. It also aims to assist supervisors in identifying practices, behaviours and attitudes that may influence the institution's risk culture (see Section 2). The paper does not define a "target" culture but provides guidance for supervisors to assess the soundness and effectiveness of a financial institution's risk culture (see Section 3).

1. Foundational elements of a sound risk culture

Risk cultures vary across financial institutions, and sub-cultures may exist within institutions, but there are certain common foundational elements that support a sound risk culture within the institution, such as effective risk governance, effective risk appetite frameworks and compensation practices that promote appropriate risk-taking behaviour. These foundational elements have been elaborated by the FSB, and financial institutions, in particular SIFIs, are expected to meet supervisory expectations set out in the following papers:

Risk governance

The FSB *Thematic Review on Risk Governance*[7] sets out sound practices for effective risk governance, including the roles and responsibilities of the board, the chief risk officer and risk management function, and the independent assessment of the risk governance framework. The report sets out an integrated and coherent list of sound practices that establish supervisory expectations for the role and responsibilities of the board as well as the stature, resources, authority and independence of the risk management and internal audit functions, including board reporting. Similar expectations for sound practices on board engagement and on stature, resources, authority and independence extend to the compliance function which has an important role to play in compliance and conduct risk control. Governance processes should be designed to work against the erosion of risk management practices through changing business and economic environments.

Risk appetite

The FSB *Principles for an Effective Risk Appetite Framework*[8] set out key elements for: (i) an effective risk appetite framework, (ii) an effective risk appetite statement, (iii) risk limits, and (iv) defining the roles and responsibilities of the board and senior management in establishing the approved risk appetite statement. Embedded in these Principles is the assumption that financial institutions have the processes to establish their strategy and develop their business

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7 See http://www.financialstabilityboard.org/publications/r_130212.pdf.

8 See http://www.financialstabilityboard.org/publications/r_131118.htm.

plan, and the models and systems to measure and aggregate risks. A sound risk culture is a substantial determinant of whether an institution is able to successfully execute its agreed strategy within its defined risk appetite.

Compensation

The FSB *Principles* and *Standards for Compensation Practices*[9] aim to ensure effective governance of compensation, alignment of compensation with prudent risk taking and effective supervisory oversight and stakeholder engagement in compensation. An employee's compensation should take account of the risks that the employee takes on behalf of the financial institution and the employee's performance in meeting the institution's risk, compliance, and other important policies. Compensation should take into consideration prospective risks as well as risk outcomes that are already realised. Other incentives, including performance reviews and promotions, should be supported by clearly formulated and well-documented processes.

2. Indicators of a sound risk culture

Assessing risk culture is complex. But given its importance attention must be paid to it. There are several indicators or practices that can be indicative of a sound risk culture. Institutions and supervisors can build awareness of the institution's balance between risk-taking and control by considering such factors. These indicators can be considered collectively and as mutually reinforcing; looking at each indicator in isolation will ignore the multi-faceted nature of risk culture.

> The indicators below are not exhaustive and do not represent a checklist or an end-point for supervisory review of an institution's risk culture.

These indicators include:

- *Tone from the top*: The board[10] and senior management are the starting point for setting the financial institution's core values and expectations for the risk culture of the institution, and their behaviour must reflect the values being espoused. A key value that should be espoused is the expectation that staff act with integrity (doing the right thing) and promptly escalate observed non-compliance within or outside the organisation (no surprises approach). The leadership of the institution promotes, monitors, and assesses the risk culture of the financial institution; considers the impact of culture on safety and soundness; and makes changes where necessary.
- *Accountability:* Relevant employees at all levels understand the core values of the institution and its approach to risk, are capable of performing their prescribed roles, and are aware that they are held accountable for their actions in relation to the institution's

[9] See FSF, *Principles for Sound Compensation Practices*, April 2009 and FSB, *Principles for Sound Compensation Practices Implementation Standards*, September 2009 (http://www.financialstabilityboard.org/activities/compensation/index.htm).

[10] The term board refers to the oversight function and the management function in general and should be interpreted throughout the document in accordance with the applicable law within each jurisdiction. Recognising that different structural approaches to corporate governance exist across countries, this document encourages practices that can strengthen checks and balances and sound risk governance under diverse structures.

risk-taking behaviour. Staff acceptance of risk-related goals and related values is essential.

- *Effective communication and challenge*: A sound risk culture promotes an environment of open communication and effective challenge in which decision-making processes encourage a range of views; allow for testing of current practices; stimulate a positive, critical attitude among employees; and promote an environment of open and constructive engagement.
- *Incentives*: Performance and talent management encourage and reinforce maintenance of the financial institution's desired risk management behaviour. Financial and non-financial incentives support the core values and risk culture at all levels of the institution.

The following sets out some general guidance for supervisors in focusing on a financial institution's culture in managing risk as they conduct their ongoing supervisory work. The indicators are not exhaustive and do not represent a checklist or an end-point for supervisory review of an institution's risk culture.

3. General supervisory guidance

Since the global financial crisis, supervisory approaches are increasingly becoming more direct and more intense to promote the resilience of the financial system. The challenge for supervisors is to strike the right balance between taking a more intensive, proactive approach and not unduly influencing strategic decisions of the institution's management. Risk culture is an area where a growing number of supervisory authorities are taking a more active role, and the range of supervisory approaches toward assessing risk culture varies.[11]

Supervisors are in a unique position to gain insights on risk culture at financial institutions given their access to information and individuals across the institution, as well as the results of supervisory work. This unique view and the ability to gather observations across multiple institutions enable peer analysis and suggest issues that both supervisors and institutions should look at. Supervisors should adopt a process to synthesise periodically supervisory findings, look for common themes, aggregate informal observations they have about the institution and apply high-level judgement in deciding whether culture or undesired behaviour is a root cause of supervisory findings. Supervisors should recognise that every supervisory activity can add information that informs these periodic assessments, but that single supervisory results are rarely a definitive indicator of culture issues that need to be addressed.

Evidence should be gathered from the full range of supervisory activities so as to avoid the assessment of risk culture being perceived and managed as a compliance-driven exercise. The lists of possible indicators should be treated as a starting point for those assessments. Supervisors should avoid supervisory methodologies that treat these indicators as a checklist. Which indicator, or indicators, is most relevant to a particular situation will vary. In some cases, underlying factors not specifically mentioned in the detailed indicators will be the source of what the indicators are showing.

[11] Some authorities have been consulting or hiring behavioural psychologists while others have conducted horizontal reviews on an institution's decision-making process or reputational risk management.

Discussions with boards and senior management will help form the supervisory view of the institution's risk culture. Supervisory observations on culture issues should be further discussed with members of the board and senior management so as to promote and develop a shared understanding of the institution's risk culture. Identification of a practice or attitude that is not supportive of sound risk management should be brought to the attention of the board or senior management, as appropriate, who have ultimate responsibility for outlining and overseeing the financial institution's risk culture, to influence change in a positive direction. The supervisor raising, and the financial institution acting early to address, the root causes of the behavioural weakness will aid in preventing (or mitigating the impact of) particular undesired cultural norms from taking root and growing.

Supervisors should assess the processes in place by which core values are communicated, understood, embraced and monitored throughout the institution. In particular, supervisors should assess how the board and senior management systematically assess the risk culture of the institution.

Supervisors should also assess the extent to which the institution is able to define its risk culture, document the material elements that support it and actively assess gaps and areas of concern to be addressed or enhanced. The institution's willingness to sufficiently document the elements supporting its risk culture should form part of the supervisor's overall assessment.

Assessing risk culture is complex and requires a range of skills, tools and approaches. Supervisors need to develop broad-based experience and a set of appropriate skills to derive sensible assessments and interact with institutions at the senior level on the role played by their risk culture. Authorities should ensure that supervisors making these assessments are adequately trained and are able to apply experienced judgement and clearly articulate these judgements. Failure by an institution to remediate findings in relation to risk culture by a supervisor should be subject to the existing suite of supervisory options that is proportional to the size of exposures and materiality of the risks involved. Supervisors should be mindful of unintended consequences in trying to influence risk culture.

- Culture concerns behaviours and attitudes that can be difficult to assess and interpret.
- Indicators should not be treated as a checklist or looked at in isolation.
- Supervisors who interact with boards on their observations need to be senior, properly experienced and able to exercise judgement.

3.1 Tone from the top

The board and senior management, in their respective roles, set expectations for the risk culture of the institution and may take a range of steps to assess the extent to which those expectations are being met, and address gaps or deficiencies identified. It is critical that the board and senior management demonstrate adherence to sound risk management and the highest standards on integrity (walking the talk), as over time, their behaviour will be emulated by the rest of the institution. Directors with experience in other financial institutions or industries where behaviours and practices generally necessitate a sound risk culture (e.g., healthcare, nuclear energy) can play an important role; non-executive directors are often particularly well placed to bring a fresh perspective and sage advice about issues such as behaviours in relation to overall culture. It is the overarching responsibility of the board and senior management to set the tone at the top, including by clearly articulating the underlying values that support the desired risk culture and behaviours; recognising, promoting and rewarding behaviour that reflects the stated risk culture and its core values; and systematically monitoring and assessing the actual culture. The board and senior management should proactively address behavioural issues and assess whether they are clearly and effectively articulating and monitoring core values and expected behaviours toward risk.

The appropriate tone and standard of behaviour 'from the top' is a necessary condition for promoting a sound risk culture and for ensuring that it is appropriately embedded within the institution. However, it is far from sufficient. For lasting change, the tone and behaviour 'in the middle' is also important to fostering a sound risk culture as it is a channel through which risk culture practices are cascaded further down an institution. Middle-level managers transmit the culture that is derived from leadership to the business lines that have a fundamental role in undertaking risks within the assigned limits of risk exposure and are responsible for identifying, assessing and controlling the risks of their businesses.

Indicators of tone from the top

Leading by example

3.1.1 The board and senior management have a clear view of the risk culture to which they aspire for the financial institution and of the behavioural and organisational consequences of this culture, systematically monitor and assess the prevailing risk culture and proactively address any identified areas of weakness or concern.

3.1.2 The board and senior management, consistently within their specific roles and responsibilities, promote through behaviours, actions and words, a risk culture that expects integrity and a sound approach to risk management as well as promotes an open exchange of views, challenge and debate.

3.1.3 The board and senior management promote healthy scepticism that encourages and supports openness to challenge by providing alternate points of view that may result in a better decision, ensuring that all directors have the tools, resources and information to carry out their roles effectively, particularly their challenge function.

3.1.4 The board and senior management are committed to establishing, monitoring, and adhering to an effective risk appetite framework, supported by appropriate risk appetite statement(s) that underpin the financial institution's risk management strategy, and is integrated with the overall business strategy.

3.1.5 Mechanisms are in place, such as talent development, succession planning, and confidential 360 degree review processes, to ensure that decision-making is not dominated by any one individual or small group of individuals in a manner that is detrimental to the interests of the institution as a whole.

3.1.6 Senior management is subject to the same expectations for integrity, risk governance, and risk culture as all other employees; that is, mechanisms are in place to subject them to incentive structures, which may include impacts on compensation, role and responsibilities, or termination.

Assessing espoused values

3.1.7 The board and senior management systematically assess whether the espoused values are communicated and proactively promoted by management and staff at all levels so that the 'tone at the middle' and throughout the institution is consistent with the 'tone at the top'.

3.1.8 The board and senior management assess whether the institution's risk appetite framework and business strategy are clearly understood and embraced by management and relevant staff, and effectively embedded in the decision-making and operations of the business.

Ensuring common understanding and awareness of risk

3.1.9 Appropriate mechanisms are in place to ensure the risk appetite, risk management strategy, and business strategy are effectively aligned and embedded in decision-making and operations at all appropriate levels of the institution.

3.1.10 The board and senior management have clear views on the business lines considered to pose the greatest challenges in the management of risk, such as business lines with unexpected or unexplained results or business lines with non-financial risks that may not necessarily lend themselves to immediate and easy quantification, and these are subject to constructive and credible challenge about the risk-return balance.

3.1.11 The board and senior management systematically monitor how promptly and effectively issues raised by the board, supervisors, and all control functions are addressed by management.

Learning from past experiences

3.1.12 Processes are in place so that deficiencies in risk management, either in respect of its design, setup or implementation, are reviewed at the appropriate levels of the institution, with a view to identifying the root causes leading to the deficiencies and taking the opportunity to strengthen the financial institution's risk culture.

3.1.13 Assessment and communication of lessons learnt from past events, both failures and successes, are seen as an opportunity to enhance the institution's risk culture, and to enact real changes for the future.

3.2 Accountability

The board and senior management 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 behaviours toward risk. In particular, business lines, the risk management function, compliance, internal audit and other control functions have clearly delineated responsibilities in regard to monitoring, identification, management and mitigation of risk. Accountability speaks to the prompt identification, management, and escalation of emerging and unexpected risk issues, and having a clear understanding of the consequences for not doing so, while retaining day-to-day operating management of risk with the units originating them. The escalation of adverse events is not intended to transfer accountability of the core issue to other individuals or groups.

Indicators of accountability

Ownership of risk

3.2.1 Clear expectations are set with respect to the monitoring and reporting of, and response to, current and emerging risk information across the institution, including from business lines and risk management to the board and senior management.

3.2.2 Mechanisms are in place for the sharing of information on emerging, as well as low probability, high impact risks, both horizontally across business lines and vertically up the institution.

3.2.3 The chief executive officer, senior management and employees throughout the institution, are held accountable for their actions and understand the consequences if they are not aligned with the institution's core values, risk appetite and risk culture, regardless of whether their actions or behaviours resulted in direct financial gain or loss to the financial institution.

Escalation process

3.2.4 Appropriate escalation processes are established to support risk management and clear consequences for non-compliance with escalation procedures are defined.

3.2.5 Systematic assessments are conducted on whether employees are aware of escalation processes and believe the environment is open to critical challenge.

3.2.6 Mechanisms are established for employees to elevate and report concerns when they feel discomfort about products or practices, even where they are not making a specific allegation of wrongdoing.

3.2.7 Appropriate whistleblowing procedures are in place and are expected to be utilised by employees without any reprisal, to support effective compliance with the risk management framework; the treatment of whistle blowers is clearly articulated and followed in practice.

Clear consequences

3.2.8 Consequences are clearly established, articulated and applied for anyone engaged in, or supporting, risk-taking that is excessive relative to the financial institution's risk appetite statement, regardless of whether positive revenue or net income was generated.

3.2.9 Breaches in internal policies, procedures and risk limits, as well as non-adherence to internal codes of conduct, are understood to have a potential impact on an individual's compensation and responsibilities, can affect career progression and, depending on severity, may result in termination.

3.3 Effective communication and challenge

A financial institution's sound risk culture encourages transparency and open dialogue within the board and between (a) management and the board, and (b) management and staff, on all levels and at all points in the process of development, marketing, implementation and maintenance of a product, service or transaction, in order to promote the identification and escalation of risk issues (i.e., make it easy for staff to "raise their hand"). In order to promote a culture of effective communication and challenge, mechanisms are established to facilitate communication, bring alternate views to the decision-making process, and provide ongoing training on the institution's desired behaviours. Evidence of a culture that is open to challenge is often reflected in decision-making processes as well as broader interactions and processes.

Open to alternate views

3.3.1 Alternate views or questions from individuals and groups are encouraged, valued and respected and occur in practice. A culture of open communication and collaboration is constantly promoted to ensure that each employee's view is valued and the institution works together to strengthen risk-related decision making.

3.3.2 Mechanisms are in place so that alternate views can be expressed in practice, as well as regular assessments of the openness to robust challenge at all layers of governance and how it is embedded within the decision-making process.

Stature of control functions

3.3.3 Control functions (e.g. risk management, internal audit, compliance) share the same stature as the business lines, actively participate in committees and are proactively involved in all relevant risk decisions and activities.

3.3.4 Control functions operate independently, have appropriate direct access to the board and senior management and a process is in place for them to periodically report to the board.

3.3.5 Control functions, including their respective representatives, have sufficient stature not only to act as advisors, but to effectively exert control tasks with respect to the institution´s risk culture.

3.4 Incentives

The power of a positive culture in risk management lies in its ability to motivate employees to want to control risks because sound risk taking is valued and enforced. Remuneration, performance evaluation and promotion systems reward servicing the greater, long-term interests of the financial institution and its clients, including sustained profitability, as opposed to short-term revenue generation. This requires sophisticated systems that appropriately estimate, price and allocate the cost of risk within the institution. Risk management and compliance considerations have sufficient status in driving compensation, promotion, hiring, and performance evaluation within the business units. Compliance with the overall risk management framework is a significant part of the professional development, appraisal, evaluation, promotion and compensation programs of the institution.

Indicators of incentives

Remuneration and performance

3.4.1 The compensation structure supports the institution's espoused core values and promotes sound risk-taking behaviour and is supported by a well-documented process.

3.4.2 Remuneration and performance metrics consistently support and drive the desired risk-taking behaviours, risk appetite and risk culture of the financial institution, and encourage employees to act in the interest of the greater good of the company, rather than for themselves or their business line.

3.4.3 Annual performance reviews and objectives-setting processes are linked to promoting the institution's desired core values and behaviours as well as compliance with policies and procedures, including addressing in a timely manner deficiencies highlighted by internal audit and supervisory findings.

3.4.4 Incentive compensation programs systematically include individual and group adherence to the financial institution's core values and risk culture, including treatment of customers, cooperation with internal control functions and supervisors, respect of risk limits, and alignment between performance and risk.

Succession planning

3.4.5 Succession planning processes for key management positions include risk management experience and not only revenue-based accomplishments; for instance, individuals with responsibilities consistent with the chief risk officer, chief compliance officer, and chief audit executive can be considered as potential candidates for executive positions, including the chief executive officer.

Talent development

3.4.6 Understanding key risks, essential elements of risk management, and the institution's culture is considered a critical skill set for senior employees and reflected in their development plans.

3.4.7 Job rotation between control functions and business lines is considered a way to facilitate a virtuous cycle for bringing business knowledge to the control functions and introducing risk awareness to the decision-making process of the business line.

3.4.8 Training programs are available for all staff to develop risk management competencies and, more broadly, the elements supporting a sound risk culture, including effective challenge and open communication.