## Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td>1</td>
</tr>
<tr>
<td>Controlling risk appetite</td>
<td>2</td>
</tr>
<tr>
<td>Eurozone banking union: what will it mean for banks?</td>
<td>6</td>
</tr>
<tr>
<td>ECB comprehensive risk assessment: single supervisory mechanism</td>
<td>9</td>
</tr>
<tr>
<td>The Basel Committee fundamental trading book review: the fog is lifting</td>
<td>11</td>
</tr>
<tr>
<td>Assessing risk culture: questions firms should be asking. An outcomes-based approach to culture for supervisors and firms</td>
<td>16</td>
</tr>
<tr>
<td>Contact information</td>
<td>25</td>
</tr>
</tbody>
</table>
Introduction

Global Regulatory Network

EY’s Global Regulatory Network is an integral part of our Financial Services Office and enables EY to offer banks deep experience, leadership and insights on financial regulation. This is a quarterly publication which compiles select briefing papers published by the Global Regulatory Network.

Our global regulatory services are led by an executive team of former senior regulators, including former Basel Committee Secretary General Stefan Walter. This team, supported by more than 100 other former regulators, drives EY’s strategic outlook on global regulatory themes impacting global banks, including capital, liquidity, resolution and recovery planning, risk governance and other emerging topics in banking regulation.

Stefan Walter is the former Secretary General of the Basel Committee on Banking Supervision from 2006 to 2011. During this time, he was also a member of the Financial Stability Board. He has more than 20 years of international bank supervisory experience, including 15 years at the Federal Reserve Bank of New York.

Dr. Tom Huertas is a former member of the FSA’s Executive Committee. He also served as Alternate Chair of the European Banking Authority, as a member of the Basel Committee on Banking Supervision and as a member of the Resolution Steering Committee at the Financial Stability Board.

Patricia Jackson is the former head of the Bank of England Regulatory Policy. She was the head of the Financial Industry and Regulation Division from 1995 to 2003 and was a member of the Basel Committee from 1995 to 2003. She chaired the global Quantitative Impact Studies to test the effect of Basel II and chaired the Calibration subgroup.

Don Vangel, Regulatory Advisor to the Office of the Chairman, joined EY after a 17-year career at the Federal Reserve Bank of New York where he ultimately served as a Senior Vice President for Bank Supervision.

Marc Saidenberg was a senior vice president and director of supervisory policy at the FRB of New York. He also represented the bank on the Basel Committee and served as co-chair of the committee’s Working Group on Liquidity. He was actively involved in the development of the Basel III capital and liquidity standards, supervisory expectations for capital planning, liquidity risk management and RRPs.

Urs Bischof is the former head of Risk Management of the Extended Executive Board of Switzerland’s FINMA. His responsibilities included risk management supervision and oversight and prudential regulations along with leadership roles with respect to Basel III, SIFI regulation, payments and clearing.

Marie-Helene Fortesa has extensive regulatory experience. Her posts have included leadership roles at the Autorité de Contrôle Prudentiel (French Prudential Supervisory Authority), the Association Française des Banques (French Banking Association) and INSEE (French National Institute for Statistics and Economic Studies), as well as senior roles at a leading investment bank.

John Liver’s experience includes a number of regulatory roles with leading investment banks as well as the UK FSA and its predecessors. His roles include head of thematic supervision in the investment firms division, head of Personal Investment Authority supervision overseeing the sales regulation of the life and pensions industry, and management roles in the investment management regulator Investment Management Regulatory Organization’s enforcement and supervision departments.

Phil Rodd, Keith Pogson and David Scott have extensive experience working with regulators across the Asia-Pacific region. Hidekatsu Koishihara is a former Chief Inspector and Inspection Administrator for the Japan Financial Services Agency. He also worked at the Ministry of Finance of Japan (MOF), Japan’s former financial regulator, serving as the financial inspector at the Bank Bureau of MOF and Financial Inspection Division and Minister’s Secretariat of MOF.
Controlling risk appetite
Published October 2013
Controlling risk appetite is central to good risk governance. \(^1\) This subject is rising up the supervisory agenda, as a recent paper from the Financial Stability Board (FSB)\(^2\) illustrates. This note summarizes the state of play and the steps that banks should take.

**The FSB’s risk appetite framework**

The FSB paper essentially makes two points:

1. Banks need an effective risk appetite framework (RAF).

2. It is the responsibility of the board to make sure that the bank has one and the responsibility of the CEO, CFO and CRO to develop and implement one.

According to the FSB, the RAF should set the basis on which the bank takes risk to implement its strategy and accomplish its business objectives. The RAF, therefore, constitutes the bank’s “overall approach” to risk-taking, and it includes “policies, processes, controls, and systems through which risk appetite is established, communicated, and monitored.” The RAF should take both a top-down and bottom-up perspective, and it should assure that the two are consistent with and reinforce each other. And the RAF should not only apply at the overall group level, but also at each of the group’s principal legal vehicles.

Banks need to write risk appetite statements (RAS) that articulate their risk appetite frameworks in a way that enables the business to implement the framework and provides the top-down perspective. The RAS should state “the aggregate level and types of risk that a firm is willing to accept in order to achieve its business objectives.” The RAS should cover all risks, including those that are hard to quantify, such as operational and business conduct risk. The RAS should combine quantitative measures, such as the impact that risk-taking could have on earnings, capital and liquidity, as well as qualitative measures, such as the impact that risk-taking could have on the bank’s reputation.

Above all, the RAS should assure that the bank’s risk appetite fits within the bank’s risk capacity. The FSB defines “risk capacity” as “the maximum level of risk the firm can assume before breaching constraints determined by regulatory capital and liquidity needs and its obligations, also from a conduct perspective, to depositors, policyholders, other customers, and shareholders.” Risk appetite is “the aggregate level and types of risk a firm is willing to assume within its risk capacity to achieve its strategic objectives and business plan.”

Risk limits embody the bottom-up perspective. They “allocate the firm’s aggregate risk appetite ... to business lines, legal entities, specific risk categories, concentrations, and as appropriate, other levels.” In aggregate, the composite provided by the collection of risk limits should mesh with the top-down statement of risk appetite.

According to the FSB, the bank’s board of directors should assure that the bank has a sound RAF — further evidence of the increasing responsibility for good governance that supervisors are demanding that boards assume. Management should be responsible for the development of the RAF. The CEO (with the support of the CFO and the CRO) should set the tone from the top, so that the RAF and RAS influence the risks the bank decides to take or not to take and how the bank manages the risks it does take. In short, the CEO should see that the RAF and the RAS are embedded in the culture and operations of the firm. In particular, the CEO should see that risk appetite remains within risk capacity. The actual development of the RAF and RAS, including setting risk limits and monitoring adherence to risk appetite, should fall largely to the CFO and the CRO. Internal audit should verify that the RAF is in place and working as it should. The FSB emphasis on management’s roles with respect to a bank’s RAF is part and parcel of the greater supervisory emphasis on individual responsibility and accountability.

Supervisors will increasingly look to assure themselves that banks embed the risk appetite framework into their day-to-day, and strategic decisions, so that the risk culture of the bank is a conservative one. Hence supervisors are likely to migrate, possibly quite quickly, from a “show me the RAF document” to “show me that the RAF is working.” This will require the bank to integrate the RAF with its limit-setting and risk acceptance processes, as well as integrate the RAF with its capital, liquidity and strategic planning.

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\(^1\) On risk governance, see GRN Executive Brief, Getting risk governance right, July 2013. [http://www.ey.com/Publication/vwLUAssets/Global_Regulatory_Network_Executive_Briefing_-_Getting_risk_governance_right/$FILE/EY_Global_Regulatory_Network_Executive_Briefing_Getting_risk_governance_right.pdf]

Implementing the FSB risk appetite framework

Banks have started to implement risk appetite frameworks. According to a recent survey on risk management that EY conducted for the Institute of International Finance, “the majority of banks have put in place risk appetite statements at least at the enterprise or group level, but the challenge continues to be embedding the risk appetite down through the organization.”\(^3\) In particular, banks found it challenging to:

- Cascade risk appetite through the organization
- Develop risk metrics that are tied to business decisions and compensation
- Create a link between risk appetite and the planning process

To overcome the first two obstacles, it helps considerably to have a shared vocabulary for the common measurement of risk. In EY’s view, the best “language” to use is the absolute amount of loss that could result if a risk were to crystallize. This enables the bank to compare and combine different types of risk into an overall measure, as well as to cascade the group’s overall risk appetite into lines of business and legal vehicles.

This language of loss is relatively straightforward to apply for market and credit risks, given the extensive modelling that banks have undertaken for such risks over the years. But further work is needed to estimate the losses that could result from taking liquidity risk (both market and funding liquidity risk), as well as to measure the losses that could result from taking “more difficult to quantify” risks, such as operating and conduct risks.

It is unlikely that supervisors will simply accept, as part of the RAS, assertions to the effect that the bank has zero tolerance for a loss from conduct or operational risk. Although supervisors may find such an ambition laudable, they are likely to press the bank very hard on how it plans to realize such an ambition – particularly in the wake of the severe losses that banks have incurred over the past few years from market misconduct (e.g., LIBOR), product mis-selling (e.g., payment protection insurance in the UK) or unauthorized trading. At a minimum, banks should have in place the measures necessary to identify and control such risks, along with a plausible explanation as to why such measures will in fact limit losses to the amount set in the bank’s RAS. Pattern recognition tools can be particularly effective in this regard, as they can give early warning of emerging conduct or operational risks.

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\(^3\) Remaking financial services: risk management five years after the crisis: a survey of major financial institutions. EY and Institute of International Finance, iif.com, July 2013. [http://www.ey.com/Publication/vwLUAssets/Remaking_financial_services_-_risk_management_five_years_after_the_crisis_-_Complete/$FILE/EY-Remaking_financial_services_risk_management_five_years_after_the_crisis.pdf]
With respect to linking the RAF and the RAS to the planning process, the challenge is to assure that risk appetite remains within risk capacity. This poses significant issues, starting with the measurement of risk capacity itself. In the shared vocabulary proposed above, risk capacity represents the aggregate absolute amount that the bank could lose before it reaches the point of non-viability. In other words, risk capacity largely represents the excess capital that the bank maintains over and above the strict minimum that it would require to remain viable.

Note that the bank may reach the point of non-viability long before it breaches minimum regulatory capital requirements, particularly if funds providers begin to lose confidence in the bank and restrict funding. Accordingly, a bank’s risk capacity will depend heavily on market conditions and may contract substantially if market conditions worsen or the economic outlook deteriorates.

If risk capacity does contract, the bank will very likely face a difficult choice. It either needs to restore capacity or reduce its risk appetite. The former may require the issuance of new capital and the possibility of dilution. The latter can pose strategic challenges for the bank. To remain competitive in various lines of business, a bank must be prepared to take certain amounts of risk. For example, a bank will not remain effective as a market maker for very long, if it stops bidding for deals in the amounts that clients expect to be able to buy or sell. Nor will a bank remain able to compete in the credit card market if it substantially cuts back customers’ limits relative to financially sound peers.

Consequently, in setting risk appetite, a bank should leave a considerable cushion between capacity and appetite. The bank should also plan on how to build capacity, both gradually through earnings retention and/or balance sheet management in order to build a basis for growth, as well as how to do so rapidly, if the bank needs to restore capacity after suffering a loss. Here, strategic balance sheet forecasting (SBSF) can help the bank rapidly ascertain the impact of various strategic options on capital, liquidity and leverage (and therefore capacity) in an integrated manner under a number of economic scenarios. SBSF can therefore enhance dialogue within the board and with supervisors, not only about the risk appetite framework, but also about stress tests and recovery planning.4

Finally, it should be emphasized that data integrity and data management are the foundation of a sound risk appetite framework. When it comes to risk management, the adage “garbage in, garbage out” certainly applies. Good data and robust processes are needed to assure that the bank is monitoring and adhering to its risk appetite. Supervisors are already demanding that banks improve their data capabilities so that they can report risk data more accurately, more rapidly and on a more granular basis, as well as use such risk information to support critical risk and business decisions. Banks should be already be taking steps to benchmark themselves against the data standards that they must meet in 2016.5

In sum, banks and investors in banks should welcome the supervisory instructions to create a sound RAF and a rigorous RAS, for such policies are simply good business. There are challenges in implementation, but these can be met.

4 For further information see the Strategic forecasting flyer: Shaping tomorrow’s business today [http://www.ey.com/Publication/vwLUAssets/Shaping_tomorrow's_business_today/$FILE/Basel_Strategic_Forecasting_flyer_FINAL.pdf]
Eurozone banking union: what will it mean for banks?
Published November 2013
The European Union (EU) is moving slowly but surely toward a banking union within the Eurozone. The EU has approved the single supervisory mechanism (SSM), and EU finance ministers have approved introduction of the European Commission's proposal for a single resolution mechanism (SRM).

So a banking union is coming, even though it may stop short of introducing a single deposit guarantee scheme. What will such a union mean for banks?

Quite a lot. Banks will have to deal with fewer supervisors, and banks may have the opportunity to manage capital and liquidity on a more integrated basis, at least within the Eurozone. But a banking union will also mean tough standards, proactive supervision and prompt resolution. Banks will have to put their houses in order, control risk more tightly and put in place robust plans for recovery and resolution.

Even though the SSM will formally begin toward the end of 2014, the imposition of tough standards is starting now. Over the coming months, the European Central Bank (ECB) will conduct what amounts to an entry examination for the approximately 130 banks that it will directly supervise under the SSM.1 The intent is to enable the ECB to start its supervisory responsibilities with a clean slate. The ECB should be confident that all banks coming under its direct supervision fully meet threshold conditions.

This entry examination will start with a detailed asset quality review (AQR) under current (non-stressed) economic conditions. The AQR will assess all aspects of the bank’s balance sheet (using 31 December 2013 as a reference point), including the level of impairments, the adequacy of provisions and the accuracy of risk-weighted assets. Then the ECB will subject the banks to a stress test that will be designed and conducted in close coordination with the European Banking Authority (EBA). To pass the combined test (AQR and stress test) banks will need to demonstrate a common equity Tier I capital ratio of at least 8% of risk-weighted assets according to the rules that will prevail at “the end of the horizon” covered by the stress test. The final results will be communicated a year from now, shortly before the ECB takes over direct supervision in November 2014. If the bank fails the combined AQR-stress test, it must take corrective action to bring its capital up to the required standard. This can involve raising new capital, selling assets or divesting lines of business.

There will be considerable pressure on banks to take pre-emptive action prior to the publication of results. Although the ECB has received assurances from Member States that public backstops will be in place, it is still unclear what they might be or how they might work. In particular, it is unlikely that the SRM will be fully operational by the end of 2014. As a result, banks and the market can expect that backstops will continue to be primarily a Member State rather than Eurozone responsibility. Banks must also recognize that if they do tap a public backstop, state-aid regulations will force them to shrink their business.

The foundation for the combined AQR-stress test will be the bank’s own data and documentation. Banks would be well advised to utilize the interval until the start of the AQR to assure that their data is up-to-date, that data on credit risk factors (e.g., loan to value ratios for mortgages) are readily accessible and linked to the relevant exposures, and that the appropriate documentation is on file. Such preparation will help the bank put its best case forward during the AQR. If the examiners conclude that the bank’s data and/or documentation is deficient, they are likely to require higher impairments and/or higher provisions as an offset. That would reduce the bank’s capital and raise the probability that the bank would be required to take remedial measures.

Once the ECB takes over direct supervision, banks are likely to find that the ECB will blend the best practices that national supervisors across the Eurozone are currently employing. In practice, supervision will demand extensive amounts of disaggregated data and use it to identify risks. So the AQR may in fact be laying the foundation for ongoing reports to the ECB. Under the ECB, supervision is likely to be forward-looking, proactive and intrusive. Indeed, the prospect that the ECB would act in such a fashion is one of the main reasons that Eurozone Member States agreed to pool responsibility for supervision.

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1 ECB Note Comprehensive Assessment October 2013 available at http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf?78631a2ae194ced468221f6173ea8759e
Banks can expect that the ECB will be quite a robust supervisor. The ECB is likely to conduct rigorous peer analysis of the Eurozone banks as well as analyze and form views on each bank’s business model. If the ECB concludes the bank has the right business model, it will assess whether management has the ability to implement the model successfully. And, if the ECB concludes that signals are not pointing in the right direction, the bank in question can expect that the ECB will exert pressure on the bank to take corrective action sooner rather than later.

That is because reforms to the resolution regime will reduce the need for the ECB to exercise forbearance. The introduction of the SRM will, together with the Bank Recovery and Resolution (BRR) Directive, go a very long way toward making banks in the EU resolvable. In other words, banks in the EU are likely to become “safe to fail,” so they can be resolved without cost to taxpayers and without significant disruption to financial markets or the economy at large. Investors, not taxpayers, are likely to bear the cost of bank failures.

To this end, the common position on the BRR requires that after 1 January 2018, fully 8% of each bank’s total liabilities be subject to bail-in, and therefore, exposed to loss. In addition, the common position requires Member States to build up a resolution fund based on contributions from banks. Such resolution funds would act as an additional backstop for an amount up to 5% of the failed bank’s liabilities. Only then could there be recourse to taxpayer funds, and this would be subject to strict limitations under state aid rules.

The reform of the resolution regime, together with forward-looking and proactive supervision, will place a premium on better risk management and more relevant and timelier disclosure. Investors who are genuinely exposed to the risk of loss can be expected to monitor and discipline the bank much more effectively (through demanding higher-risk premiums and/or constraining their exposure to the bank) than investors who expect to be bailed out by the government if the bank fails.

Consequently, banks would be well advised (and regulation may require banks) to:

► Strengthen risk governance. This includes instituting an appropriate risk appetite framework and taking steps to assure that risk appetite remains within risk capacity. Indeed, Capital Requirements Directive IV requires banks to take action in this area.

► Strengthen resilience. To do so, banks need to take recovery planning to the next level, e.g., to map out measures that will enable the bank to raise liquidity even under conditions of extreme stress. This could require the bank to establish what amounts to a “collateral budget.” This would keep track of and forecast the level of the bank’s unencumbered assets and lay out the sources and amounts of funding that might be obtained by pledging such unencumbered assets to market participants and/or official lenders, such as central banks.

► Redesign disclosure. The redesigned disclosure will be applicable to supervisors and to the market. Investors who are at risk if the bank fails are likely to demand granular, disaggregated data on the risks in the bank’s portfolio as well as increased information about where the investor’s obligation would stand in the queue, if the bank did enter resolution. Preparation for the AQR can enable banks to get a start on the former, while a so-called entity priority analysis can lay the foundation for the latter and should in any event be part of the bank’s resolution planning.

► Improve data capabilities. The key to each of the above initiatives as well as controlling cost is better data management. Non-financial firms are using big data to control costs and to compete on analytics. Banks need to do the same. They need to move away from legacy systems and take a more integrated approach to risk and finance. This will reduce cost, improve risk management and facilitate modelling of the strategic options open to the bank.
ECB comprehensive risk assessment: single supervisory mechanism
Published November 2013
The European Central Bank (ECB) has released a paper setting out the approach to be taken for a comprehensive assessment of the health of the Eurozone banking sector.1

The assessment will cover 130 banks in 18 Eurozone Member States — representing 85% of euro-area bank assets.

This assessment will be carried out prior to the ECB assuming its new supervisory role in November 2014, as part of the creation of the single supervisory mechanism (SSM) for Eurozone banks. The comprehensive assessment will conclude in October 2014.

The banks covered by the comprehensive assessment will be those that are directly supervised by the ECB. The SSM legislation gives the ECB the power to obtain all the necessary information from the national supervisors, referred to as national competent authorities (NCAs), to enable the comprehensive assessment to be made.

The assessment will have three parts:

► A supervisory risk assessment
► An asset quality review
► A stress test

The outcome from all three parts will influence the actions taken to address any revealed weaknesses. Such measures may include the requirement to raise provisions or capital levels, among other possible responses.

**Approach**

The ECB will lead the exercise by setting out the detailed design and strategy and by monitoring its execution, as well as consolidating and disclosing the results. Under the ECB’s strong oversight, the NCAs will execute the exercise at a national level. Both the ECB and NCAs will use private sector experts to support their assessments.

The comprehensive assessment has three pillars:

► Supervisory risk assessment covering key risks that include liquidity, leverage and funding risk. The assessment will encompass quantitative analysis, both backward- and forward-looking, as well as an assessment of a bank’s position relative to its peers and its vulnerability to exogenous factors. The ECB and NCAs are developing a new risk assessment system that will be a key tool in the future SSM.

► Asset quality review examining assets as of 31 December 2013. This will cover credit and market risk exposures, including a quantitative and qualitative review of hard-to-value assets and on- and off-balance-sheet positions. The review will also consider non-performing assets and forbearance. This entails breaking open loan files, assessing collateral valuations and looking at lending standards and provisioning.

► Stress test building upon and complementing the asset quality review by providing a forward view of a bank’s loss-absorbing capacity in the face of severe economic and financial shocks. The ECB and European Banking Authority (EBA) have agreed to perform the next European Union-wide stress test in close cooperation.

**Capital threshold**

A capital threshold will be set as a benchmark for assessing the outcomes of the exercise. The threshold will be 8% Common Equity Tier 1 using the capital definition as of 1 January 2014. However, the stress test will also have to take into account the definition of Common Equity Tier 1 capital in force at the end of the stress test period because the Basel III phase-in requirements will lead to a gradual tightening of the definition of capital over this period.

**Follow-up actions**

Significant weaknesses identified in the comprehensive assessment will lead to supervisory follow-up actions, such as recapitalization (through profit retention and/or new equity), a change in the funding profile or an increase in provisioning.

**Implications**

This is the most comprehensive assessment of the strength of the Eurozone’s major banks ever to be conducted on such a scale, although some peripheral countries have already carried out one or more asset quality reviews. A key question is what the available backstop provisions will be should there be capital shortfalls for some banks or banking systems. The ECB has made clear that any shortfalls should be made up from private sources of capital and, if these prove to be insufficient, public backstops might need to be drawn on.

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1 European Central Bank, Note: Comprehensive Assessment, October 2013.
The Basel Committee fundamental trading book review: the fog is lifting
Published November 2013
The Basel Committee on Banking Supervision (BCBS) recently issued for comment the consultative paper *Fundamental review of the trading book: A revised market risk framework*. This represents the second consultative document on this topic, the first having been issued in May 2012.

Since then, the BCBS has substantially firmed up the direction it proposes to take in its effort to reform the capital treatment of the trading book. Comments on the new consultative paper were due 31 January 2014. In parallel, the BCBS also initiated a quantitative impact study to assess the capital implications of the proposal.

A key objective of the *Fundamental review of the trading book* (FTBR) is to address outstanding issues not fully addressed by the “Basel 2.5” market risk reforms, including the need to further address the boundary between the banking and trading books, and to enhance the capitalization of credit risk and market liquidity risk in the trading book. Moreover, the FTBR needs to be seen in the broader context of two related initiatives. The first is the effort of the BCBS to promote greater consistency in risk-weighted asset (RWA) outcomes across banks. A study on RWA variability of the trading book produced results that the BCBS viewed as excessive (RWA) outcomes across banks. A study on RWA variability of the trading book produced results that the BCBS viewed as excessive.

The FTBR provides a window into the direction of the BCBS’ broader RWA-related reforms. For example, the introduction of a more risk-sensitive standardized approach for market risk in the trading book is a leading indicator of what is also likely to emerge in the areas of credit risk and operational risk capital requirements. Moreover, the direction of the trading book proposal to introduce further constraints on the use of internal models will likely carry forward to these other risk areas, as would the imposition of additional disclosure requirements based on more comparable standardized and models-based approaches.

**Key features of the new proposal**

When compared to the initial May 2012 consultative paper, the direction the BCBS proposes to take in the recent FTBR is much more definitive in a number of key areas, including the following topics:

**Trading book – banking book boundary**

The Basel Committee has agreed on an approach for setting the boundary between the trading and banking book. The revised boundary set forth by the Basel Committee is based on the “evidence-based approach” that was presented in the May 2012 paper, that is, banks must not only demonstrate the intent to manage positions as trading but also the ability to do so. Moreover, there is a presumption that certain exposures must be included in the trading book (for example, net short risk positions in a banking book equity position), unless they do not meet criteria such as being able to be fair valued daily through the income statement or are specifically required to be treated as banking book positions for regulatory capital. (Positions such as unlisted equities, securitization warehouse positions, real estate holdings and equity investments in funds where the bank cannot look through the fund for real prices are cited by the Basel Committee as positions that would require banking book treatment.)

Banks also would be required to provide data to the supervisor demonstrating that positions are being actively traded and

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1 Basel Committee on Banking Supervision, Regulatory consistency assessment programme (RCAP) - Analysis of risk-weighted assets for market risk, January 2013.
managed, once included in the trading book. A number of the
data elements for monitoring turnover and P&L attribution are
comparable to those of the proposed Volcker Rule for determining
whether an activity can be considered “market making.”
There may be opportunities for banks subject to both sets of
requirements to leverage what is done for one to address both.

In addition, it would only be possible to move positions from the
trading book to the banking book and vice versa under very strict
and rare circumstances, as defined by the Basel Committee and
subject to supervisory approval. Moreover, it would not be possible
to obtain a regulatory capital benefit when moving exposures from
one book to another.

The outcome of this new trading book definition would be to
make it much less likely that illiquid exposures could find their
way into the trading book or that they would be supported by
insufficient capital, as was the case in the lead-up to the recent
financial crisis. There would also be much more consistency
across banks as to what could be included in the trading book,
and the ability to arbitrage different capital requirements by
choosing either banking book or trading book treatment would be
significantly limited.

“The FTBR will result in a complete
overhaul of the current capital treatment
for banks’ trading activities. Banks will
have to redesign their internal regulatory
capital models, build a new standardized
approach and demonstrate a wide range
of capabilities to meet supervisory
expectations.”

The Basel Committee has also agreed to consider the development
of a Pillar 1 charge for interest rate risk and credit spread risk in
the banking book. This, in part, represents a compromise toward
those BCBS members who favored a so-called valuation-based
approach to the trading book/banking book boundary, instead
of the evidence-based approach that is now being pursued. The
valuation-based approach would have included available-for-sale
securities in the trading book definition. The concern is that there
are also structural market risk exposures in the banking book,
including available-for-sale securities used for asset-liability and
liquidity risk management that are not captured adequately under
the current Basel II framework. A revised approach to interest rate
risk in the banking book could address these additional concerns.

The standardized approach
The Basel Committee has specified in detail how a bank would
be expected to calculate the standardized capital requirement
for each of the major risk factors: interest rate risk, credit
risk, equity risk, commodities, foreign exchange and options
exposures. In contrast to the current standardized approach
of the Basel framework, there would be greater recognition of
hedges and diversification benefits. As a result, the capital cost
of not permitting a bank to use an internal models approach for a
particular desk is likely to be less than is currently the case.

The internal models approach
Whether a bank is permitted to use the internal models approach
or required to apply the standardized approach will be determined
at a desk-by-desk level. The decision is based on a range of tests
that must be performed, including how well the bank’s models
predict the P&L at the trading desk level, as well as the quality of
the data supporting the models.

In addition, the Basel Committee has introduced a “model-
indeed independent risk assessment tool” for determining whether a
desk is permitted to use an internal models approach. This tool
essentially applies the leverage ratio at the desk level, and if
a bank’s internal model produces a capital result below some
threshold established by this model-independent leverage
measure, the bank’s application for using its internal model
would be rejected. One problem with this measure is that it assumes a
stable relationship between internal modelling techniques and
the much simpler leverage type measure, which is unlikely to be
the case.

All banks that have received internal models approval would
have to use the so-called expected shortfall (ES) approach to
calculate their market risk capital requirement measured at the
proposed 97.5% confidence level and calibrated to a period of
significant financial stress. The Basel Committee describes the
97.5% confidence interval as providing a broadly similar level of
risk capture as the current 99% value-at-risk (VaR) threshold
requirement, while providing benefits including generally more
stable model output and less sensitivity to extreme outlier
observations. In addition, replacing the current requirement to
calculate VaR and stress VaR with a single ES measure will simplify
the regulatory capital framework for market risk.
Banks would be required to incorporate into their ES model a series of liquidity horizons specified by supervisors, which range from 20 days to one year, based on the type of risk factor being modelled. This is in contrast to the current framework, which allows liquidity horizons as short as 10 days and leaves it to the banks to arrive at the appropriate horizons for less liquid positions. While the Basel Committee has tried to balance simplicity and risk sensitivity, the lack of differentiation between liquid and illiquid products within broad risk categories (e.g., no distinction between G7 versus other currencies) could be costly for firms trading in the more liquid spectrum of a given product class.

Banks will also be constrained in their ability to recognize diversification benefits across risk factors and trading desks. Currently, no such constraints exist.

Banks would be required to use much longer data histories, going back at least 10 years, which is much more stringent than the current requirement. While the Basel Committee has provided certain shortcut techniques to help banks meet the longer data horizon requirement, it will nevertheless become more challenging to obtain the necessary data to obtain supervisory model approvals.

Securitization exposures may not be modelled, nor would so-called correlation trading desk exposures; this effectively eliminates the use of the comprehensive risk measure (CRM) for correlation trading portfolios, which will now be subject to the standardized approach treatment.

Credit exposures in the trading book would be subject to a stand-alone model outside of the ES measure using an incremental default risk charge (IDRC) that is to be calibrated consistently to the banking book credit capital charges by using a one-year time horizon and 99.0% confidence interval. The credit spread risk charge for migration risk will be modelled as part of the total capital charge within the ES measure. In addition, the BCBS proposes to restrict the types of models and assumptions that may be used for measuring credit risk exposures.

Of note, while the first consultative document discussed whether credit valuation adjustments (CVA) should be captured in an integrated manner with other forms of market risk under the market risk capital framework, the Basel Committee has decided that for now, CVA must be treated separately given the complexity and model risk of an integrated framework.

Relationship between the standardized and internal models approach

The standardized approach will be more risk sensitive than is currently the case, while additional constraints are to be placed on the internal models approach, such as restrictions on diversification benefits, as discussed in the previous section. Both approaches will be subject to common assumptions in how they are to be calibrated, for example, by applying a consistent historical period of significant stress. As a result, the two approaches are converging toward each other. This greater desk-level consistency will make it easier for supervisors to “switch off” the use of internal models at a particular trading desk than is currently the case, since the current standardized approach does not adequately capture the risk of large banks’ trading strategies, and therefore results in punitive capital requirements.

Public disclosure

The BCBS has set forth a prescriptive set of disclosures for trading book risks at the desk level. Currently, banks must only make disclosure at the aggregate trading book level. All banks, even those under internal models approaches, will be required to calculate and disclose the results of the standardized approach. This would promote a comparable disclosure measure across banks. Banks with model approval will also have to provide detailed qualitative and quantitative desk-level, model-based disclosures.
Next steps and the way forward

While all aspects of the proposal are still open for comment, there are a number of key elements that have yet to be specified. They include the following:

► The calibration of the standardized approach capital requirements relative to the internal models approaches
► The degree of diversification benefits that will be permitted under the standardized approach and the internal models-based approach
► Whether the standardized approach will ultimately serve as only a benchmark to the internal models-based calculation, or as a floor or surcharge
► The appropriate implementation horizon for meeting the new requirements
► The calibration of the "independent measure" for deciding whether a bank can use its internal model at the desk level

Given that many of the core aspects of the proposal are unlikely to change substantially, banks can begin performing gap analyses against the heightened expectations for trading book and internal modelled treatment, and related disclosures. It will be particularly important that banks assess how current market risk approval programs are consistent with the investments already incurred to comply with Basel 2.5, the precursor to the FTBR.

Banks also will need to develop policies for what can be included in the trading book, how their trading desks are to be structured and which models will require supervisory approval. As part of this process, banks will need to develop new measurement methodologies that meet the heightened standards of the FTBR, and they will need to develop new validation techniques to demonstrate to the supervisors that internal models are performing as expected. Finally, banks will need to rethink their approach to public disclosures. If such disclosures end up requiring transparency around both the standardized and the internal models-based approaches, as currently proposed, banks would need to be in a position to explain the differences in a manner that maintains the integrity of their internal approaches.
Assessing risk culture: questions firms should be asking. An outcomes-based approach to culture for supervisors and firms

Published January 2014
This Global Regulatory Network (GRN) briefing highlights the key elements of the recent Financial Stability Board (FSB) Consultative Document and provides banks with practical tools to assess their risk culture against the FSB expectations.

**An outcomes-based approach to culture for supervisors and firms**

A “strong risk culture in firms is essential to their safety and soundness and to financial stability”. Risk culture has moved to the front of the global regulatory agenda, and the FSB paper lays out the outcomes or behaviors supervisors will expect to see when they assess culture in firms. While a draft, the paper provides insight to the future direction of global supervision, particularly for large firms.

The FSB paper is directed to supervisors, but it can help firms as they grapple with their own cultural assessments. The need to address culture in firms was highlighted in EY’s 2013 survey of major financial institutions. It notes, “[T]here is agreement that aligning the board, the leadership team and the business units of a firm around a shared understanding of risk culture is crucial to changing, monitoring and managing behaviors.”

**Key elements of a sound risk culture**

The FSB paper builds on previous FSB work in governance, risk appetite and compensation, suggesting that these three factors are key contributors to a sound risk culture in firms. Accordingly, large firms are expected to meet supervisory expectations in each of these areas:

- The FSB Thematic Review on Risk Governance – One of the most wide-ranging FSB papers to date, this report sets out supervisory expectations for risk governance. The report discusses the roles and responsibilities of the board, the Chief Risk Officer (CRO), the risk management function and the internal audit function. The paper raised the bar for the control functions: increased authority, stature and resources, and direct reporting lines to senior management and the Board. As noted in the paper, “Risk culture plays a critical role in ensuring effective risk governance endures through changing environments.”

- The FSB Principals for an Effective Risk Appetite Framework – In our October GRN Briefing Note we discussed in detail the FSB’s approach to risk appetite. The framework document, now final, sets out the key elements for risk appetite frameworks, risk appetite statements, risk limits, and the roles and responsibilities of the board and senior management. For firms, risk culture will determine whether strategy and risk appetite are aligned.

- Finally, the FSB principles and standards for compensation practices – Since issuance of the Principles and Standards, national supervisors have set out their own frameworks to see that compensation systems are aligned with prudent risk taking. In firms, an effective risk culture will ensure that compensation systems incent desired risk-taking behaviors and, once established, appropriate compensation systems will help sustain the risk culture.

**Outcomes – indicators of a sound risk culture**

The FSB culture paper sets aside the thorny issue of how supervisors and firms will assess culture, recognizing that there are many different approaches. Instead the paper jumps to the outcomes supervisors should be looking for. That is, rather than focus on whether a culture is good or bad – an imprecise science at best – the paper, in essence, asks, “Is the risk culture in the firm delivering the behaviors we want?”

This very practical approach will help firms as they address their own culture. The FSB’s desired outcomes, discussed below, have a supervisory bent. Firms may not agree fully with the FSB’s list, but it does provide a starting point for an assessment of a firm’s culture. Indeed firms may have an even more extensive list.

The process of implementing a firm’s culture has three main elements: (i) decide what outcomes (behaviors) the firm wants; (ii) communicate throughout the organization; and (iii) test whether those behaviors are observed, and if not, ask why. The front office, risk management, the board, senior management and internal audit will all have their roles to play.

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3 Remaking Financial Services: Risk Management Five Years After the Crisis, EY and IIF, 2013.
4 Thematic Review on Risk Governance, FSB, 11 February 2013.
5 FSB Principles for an Effective Risk Appetite Framework, FSB, 18 November 2013.
Supervisors’ assessment of culture – what firms can expect

As the FSB recommendations are implemented, firms (particularly the largest firms) can expect supervisors to incorporate assessments of risk culture into ongoing supervisory work. The report identifies the board as having ultimate responsibility for the culture of the firm. The FSB expects supervisors to raise issues in supervisory reports and to discuss issues with the board and senior management.

Timelines will differ, and supervisors will take a variety of approaches to meet the FSB’s expectations. In some jurisdictions, culture has already been incorporated in the conversation with the board and with senior management. Elements such as tone from the top, risk appetite, incentives and accountability have been part of supervisory reviews for some time. Some supervisors have reorganized, building specialized supervisory teams focusing on governance and culture. Others have hired clinical specialists to assist in cultural assessments. In some jurisdictions, supervisors will do specific reviews focusing on culture while others will embed their cultural assessments in their ongoing review work. However, supervisory work in this area is still in the early stages, and we expect supervisory practice to evolve quickly.

As noted above, firms generally accept the need for an effective risk culture and the need to define acceptable behaviors and communicate them throughout the organization. However, the FSB makes it clear that supervisors will be looking to boards to confirm that risk-taking behavior is acceptable. Firms will be asked to demonstrate to supervisors their process for defining risk culture, communicating it throughout the organization and testing behaviors. This remains a challenge for many firms.

What outcomes will supervisors look for?

The FSB points to four indicators of a sound risk culture – tone from the top, accountability, effective challenge and incentives.

► Tone from the top – The paper holds the board and senior management responsible for articulating the firm’s values that underline the risk culture, demonstrating through action the desired behaviors, holding staff accountable for their behavior and monitoring behavior throughout the organization.

► Accountability – Employees need to understand the core values of the organization’s risk culture and that they will be rewarded or held to account for their behavior.

► Effective Challenge – An effective risk culture will facilitate constructive challenges in the line of business and in control functions.

► Incentives – The old adage “if you want to understand why people behave the way they do, ask ‘how are they paid?’” is as true today as ever. In an effective risk culture, compensation and career development will be geared toward the long-term interests of the firm and linked to risk management, business conduct and compliance considerations.

The FSB paper lists many of the things that supervisors will be looking for. These are listed in the Annex to this Briefing Note. No doubt this list will evolve as supervisors gain experience in the area of risk culture.

Questions firms should be asking when assessing their own risk culture

The FSB paper makes it clear that supervisors expect boards and senior management to hold all levels of the organization accountable for their behavior and to monitor ongoing behavior. However, firms want to know how to do this. By asking the right questions, boards can confirm that their risk culture message is impacting behavior throughout the firm. Asking the right questions is crucial to ensure that all elements of the process are aligned and to ensure that actions taken to deliver the right outcomes are mutually reinforcing. In the Annex to this paper, and juxtaposed with supervisory expectations, we propose an initial list of questions boards should be asking when assessing their firm’s risk culture.
## Annex

### Indicators of tone from the top

**FSB consultative document guidance for supervisors**

### Leading by example

- The board and senior management are committed to establishing, monitoring and adhering to an effective risk appetite statement that underpins the financial institution’s risk management strategy and is integrated with the overall business strategy.
- The board and senior management have a clear view of the risk culture to which they aspire for the financial institution, systematically monitor and assess the prevailing risk culture, and proactively address any identified areas of weakness or concern.
- The board and senior management promote through actions and words a risk culture that expects integrity and a sound approach to risk.
- The board and senior management promote an open exchange of views, challenges and debate and make sure that all directors have the tools, resources and information to carry out their roles effectively, particularly their challenge function.
- The board and senior management have mechanisms in place, such as talent development and succession planning, to help lessen the influence of dominant personalities and behaviors.

### Assessing espoused values

- The board and senior management systematically assess whether the espoused values are communicated and adhered to by management and staff at all levels to ensure that the tone at the middle and throughout the institution as a whole is the same as the tone at the top.
- The board and senior management have mechanisms in place to assess whether the risk appetite statement, risk management strategy and overall business strategy are clearly understood and embraced by management and staff at all levels and effectively embedded in the decision-making and operations of the business.
- The board and senior management have established a compensation structure that supports the institution’s espoused core values and promotes prudent risk-taking behavior.

### Ensuring common understanding and awareness of risk

- The board and senior management demonstrate a clear understanding of the quality and consistency of decision-making throughout the business, including how decision-making is consistent with the financial institution’s risk appetite and the business strategy.
- The board and senior management have clear views on the business lines considered to pose the greatest challenges to risk management, such as unusually profitable parts of the business, and these are subject to constructive and credible challenge about the risk-return balance.
- The board and senior management systematically monitor how quickly issues raised by the board, supervisors, internal audit and other control functions are addressed by management.

### Sample questions boards should be asking when assessing risk culture

<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
</tr>
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<tbody>
<tr>
<td>Are the mission, vision and values clearly aligned and communicated throughout the firm?</td>
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<td>Does senior management lead by example? What is the tone from the top?</td>
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<td>Is middle management displaying the right behaviors? What process does the firm have to ensure the message is consistent, well understood and accepted throughout the firm?</td>
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<td>Is the strategy appropriate given the risk appetite, and does the risk appetite framework ensure that decisions down through the organization are consistent with risk appetite?</td>
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<td>Is risk appetite considered in corporate strategy and capital planning? Are risk outcomes articulated in strategy?</td>
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<td>Can the board point to an example where risk appetite considerations impacted strategic decision-making?</td>
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<td>Are returns commensurate with risks assumed in various businesses? Is risk accurately factored into decision-making? Are businesses ad products appropriately charged for risks undertaken?</td>
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<td>Are limits consistent with risk appetite? Are limits at the business unit level set to ensure risk appetite is not exceeded?</td>
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</tr>
<tr>
<td>Is assessing culture driven by compliance with regulatory expectations or a genuine desire to understand “how we do what we do”?</td>
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<tr>
<td>Are new businesses or products approved before controls are in place?</td>
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<tr>
<td>Is risk management part of the strategic decision process?</td>
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<tr>
<td>Are any individuals or business lines “untouchable,” that is outside the review by risk management and other internal controls?</td>
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</tr>
<tr>
<td>Do corporate values consider desired behaviors (good and bad), and is this well understood at the top, middle and bottom of the house?</td>
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</tr>
<tr>
<td>Is risk-taking behavior linked to compensation?</td>
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### Ensuring common understanding and awareness of risk

- The board and senior management demonstrate a clear understanding of the quality and consistency of decision-making throughout the business, including how decision-making is consistent with the financial institution’s risk appetite and the business strategy.
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- The board and senior management systematically monitor how quickly issues raised by the board, supervisors, internal audit and other control functions are addressed by management.

### Ensuring common understanding and awareness of risk

- What processes are in place to ensure that top-of-the-house messages are understood and accepted at the shop floor?
- Is broad risk training carried out for those in the front office as well as risk management?
- Is there training on risk appetite and the implications for non-compliance?
- What products and businesses are growing most rapidly and have the highest returns? Does the board understand why? Is it because of excessive risk taking?
Learning from risk culture failures

► The board and senior management have processes in place to ensure that failures or near failures in risk culture, internal or external to the firm, are reviewed at all levels of the organization and are seen as an opportunity to strengthen the financial institution's risk culture and make it more robust.
► Assessment and communication of lessons learned from past errors is seen as an opportunity to strengthen the institution's risk culture and to enact real changes for the future.

Does the board track outstanding recommendations from internal audit and regulators? How long are issues open?

How does the organization react to adverse events?

Is there a process in place to review control breakdowns?

How are lessons learned from the experience of other firms assessed?

Indicators of accountability

FSB consultative document guidance for supervisors

Sample questions boards should be asking when assessing risk culture

Ownership of risk

► 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 the lines of business and risk management to the board and senior management.
► Mechanisms are in place for the lines of business to share information on emerging and unexpected risks, including horizontally to other business lines and units that might be impacted.
► Employees are held accountable for their actions, regardless of whether their actions resulted in financial gain or loss to the financial institution, and are aware of the consequences for not adhering to the desired risk management behavior.

Is it clear that the front office is responsible for all aspects of risk stemming from their activities, including reputation and operational risk (i.e., first line of defense)?

How is emerging risk information transmitted across the organization?

When was the last time a business head was disciplined for exceeding risk limits, in spite of high revenue generation?

Is the board aware of the escalation process for control breaches? Are there reports indicating how often controls are breached in different business lines?

Can you point to an instance when a business head said “I don’t understand this product, we are out of this business” or “We have decided to limit further growth in this business until proper controls are in place”?

Escalation process

► Escalation processes are established and used, with clear consequences for non-compliance with risk policies and escalation procedures.
► Systematic assessments are conducted on whether employees are aware of escalation processes and believe the environment is open to critical challenge and dissent.
► Mechanisms are established for employees to raise concerns when they feel discomfort about products or practices, even where they are not making a specific allegation of wrongdoing, and for the organization to act on those concerns.
► Whistleblowing is proactively encouraged and supported by the board and senior management and understood by employees as part of an effective compliance framework. The treatment of whistleblowers is clearly articulated and followed in practice.

How are whistleblowers treated? Can you point to an instance where an individual was promoted shortly after he/she raised concerns about unacceptable risk taking?

Are limit breaches tracked or ignored? Or are limits simply raised in response?

Is the culture proactive? Do breaches in controls or unacceptable behavior have consequences?

Are requests for increases to limits rubber stamped by the board? How often are requests for limit increases rejected?

Enforcement

► Consequences are clearly established, articulated and applied for business lines or individuals engaged in risk-taking that is excessive relative to the financial institution's risk appetite statement, regardless of whether positive revenue or net income was generated. Breaches in internal policies, procedures and risk limits, as well as non-adherence to internal codes of conduct, impact an individual's compensation and responsibilities or affect career progression including termination.

When was the last time an individual was disciplined and compensation was cut as a result of unacceptable risk taking?
Indicators of accountability

FSB consultative document guidance for supervisors

Sample questions boards should be asking when assessing risk culture

Open to dissent

► Alternate views or questions from individuals and groups are encouraged, valued and respected and occur in practice.
► Senior management has mechanisms in place to ensure that alternate views can be expressed in practice and requests regular assessments of the openness to dissent at all layers of management involved in the decision-making process.

Does the board have the expertise necessary to constructively challenge business line and risk management experts?
Does the board understand the risk reports. Have risk reports been sent back to management for simplification or clarification?
Does the culture support risk transparency and enable concerns to be voiced?
Does the culture support constructive dissent? Can you cite a time when an employee raised concerns about risk taking? How did the company react?

Stature of risk management

► The CRO and risk management function share the same stature as the lines of businesses, actively participating in senior management committees and staying proactively involved in all the relevant risk decisions and activities.
► The CRO and risk management function have appropriate direct access to the board and senior management and effectively utilize it.
► Compliance, legal and other control functions, including their respective representatives, have sufficient stature not only to act as advisors, but to effectively exert control tasks with respect to the institution’s risk culture.

Does the CRO report directly to the CEO?
Does the CRO have ex ante input to strategic decisions? Are risk management and audit consulted before new products are introduced?
Do the control function heads meet in camera with board committees?
Does the board have unfettered access to the CRO, CFO and other control functions outside board meetings?
Does risk management have skills necessary to understand all products and models?
Is the role of risk management in monitoring risk clear and separate from the front office (i.e., second line of defense)?

Enforcement

► Consequences are clearly established, articulated and applied for business lines or individuals engaged in risk-taking that is excessive relative to the financial institution’s risk appetite statement, regardless of whether positive revenue or net income was generated. Breaches in internal policies, procedures and risk limits, as well as non-adherence to internal codes of conducts, impact an individual’s compensation and responsibilities or affect career progression including termination.

When was the last time an individual was disciplined and compensation was cut as a result of unacceptable risk taking?
## Indicators of incentives

**FSB consultative document guidance for supervisors**

### Remuneration and performance

- Remuneration and performance metrics consistently support and drive the desired risk-taking behaviors, 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 themselves or their business line.
- Annual performance reviews and objectives-setting processes include steps taken by the individual to promote the financial institution’s desired core values, compliance with policies and procedures, internal audit results, and supervisory findings.
- Incentive compensation programs systematically include individual and group adherence to the financial institution’s core values and risk culture, including treatment of customers and cooperation with internal control functions and supervisors; respect to risk exposure limits; and alignment between performance and risk.

### Sample questions boards should be asking when assessing risk culture

- How often do business heads say “we can’t stop offering this product; our sales force needs it”?
- Does the CRO have input to business head performance reviews?
- Does risk management have input to the performance reviews of risk takers?
- How are compensation and risk-taking behaviors linked?

### Talent development and succession planning

- Understanding key risks and essential elements of risk management and the culture of the firm is considered a critical skill set for senior employees and is reflected in development plans for employees.
- Succession planning processes for key management positions include risk management experience, not only revenue-based accomplishments. For instance, the CRO can be considered as a potential candidate for CEO.
- Training programs are available for all staff to develop risk management competencies.

- When was the last time a control function head was promoted to run a business?
- Do business heads have control function experience?
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