

Asia-Pacific Finance and Development Centre and
The Australian **APEC** Study Centre

Enhancing Supervision of Financial Institutions' Risk Appetite Frameworks

Training Workshop Report

Shanghai, China

20-23 May 2013



APEC Project: FMP 02/2012A

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APEC#213-SO-01.1

Table of Contents

	<i>Page</i>
<i>Executive Summary</i>	<i>2</i>
<i>Key Findings</i>	<i>4</i>
<i>Introduction</i>	<i>6</i>
<i>Background</i>	<i>7</i>
<i>Program Overview</i>	<i>10</i>
<i>Highlights from program discussions and workshop outcomes</i>	<i>13</i>
<i>Conclusion and Recommendations</i>	<i>19</i>
<i>Appendix 1: Selected industry initiatives and key findings on Risk Appetite and Risk Culture</i>	<i>22</i>
<i>APPENDIX 2: Training Workshop</i>	<i>25</i>

Executive Summary

The global financial crisis revealed that, as a result of the aggressive pursuit of growth in the years immediately prior to the crisis, many large banks took far too much risk, in aggregate, and that much of their risk-taking was either substantially underestimated and/or misunderstood, or the subject of insufficient attention and control. In particular, prior to the crisis, the largest and most-affected banks failed to determine and put in place appropriate boundaries for their risk-taking activities in advance, and then stick to them.

This widespread failure of large banks to define in advance the amount and type of risk that they were able and willing to assume and manage well, in pursuit of their business objectives – which is also referred to as their “*risk appetite*” – was one of the principal factors at the heart of the systemic failures of risk governance and risk management that were evident during the crisis and a major contributor to the resultant financial instability. Institutional culture also played an important role in these failures.

In the years since the global financial crisis, supervisors have sought to strengthen the oversight of financial institutions, in order to better prevent their failure and to increase the resilience of financial systems. Supervisory expectations for financial firms’ risk management functions and overall risk governance frameworks are increasing, as this was an area that exhibited significant weaknesses in many large financial institutions during the crisis.

An effective risk appetite framework, together with a strong “*risk culture*”, provides the foundation of good risk management in a financial institution. However, in its October 2011 progress report on enhanced supervision¹, the Supervisory Intensity and Effectiveness group (SIE) of the Financial Stability Board (FSB) noted that effective risk appetite frameworks (RAFs) that are actionable and measurable have not yet been widely adopted. It concluded that the development of an effective risk appetite framework is important for firms and supervisors and needs attention by both. Furthermore, the report recommended that supervisors should discuss expectations for what a “good” risk appetite framework should entail, and how to supervise against these expectations.

Following those developments, a Training Workshop was organised in Shanghai in May 2013 to enhance the capacity of supervisors of banks and other financial institutions from emerging economies within the APEC region to ensure the implementation of sound risk appetite frameworks in those institutions. The workshop was funded by APEC and organised by the Australian APEC Study Centre at RMIT University, in partnership with the Asia-Pacific Finance and Development Center, Shanghai.

The principal conclusion that can be drawn from the Training Workshop is that, as a group, the participating agencies within the region have a very substantial distance to travel in order to achieve a strong foundation of deep and widespread knowledge and understanding of the key concepts of risk appetite and risk culture throughout their agencies, and to subsequently design and implement new or enhanced supervisory practices which embed these concepts and fully reflect such understanding.

¹ Financial Stability Board, (2012), “*Increasing the Intensity and Effectiveness of SIFI Supervision*”, Progress report on implementing the recommendations on enhanced supervision:
http://www.financialstabilityboard.org/publications/r_111104ee.pdf

Such deep and widespread knowledge and understanding of these fundamental concepts, and appropriately redesigned and enhanced supervisory practices will take substantial time to achieve. Specifically, it will be very challenging for supervisory agencies to develop and implement approaches and processes to assess the effectiveness of the risk appetite frameworks in the financial institutions that they supervise, once these frameworks have been implemented in those firms. Nevertheless, this will be essential in order to strengthen risk governance in financial institutions and strengthen the resilience of financial systems throughout the APEC region.

Similarly, it will also be very challenging for supervisors to assess the risk culture within the firms that they supervise, although it will be very important to make this assessment. Performing this assessment will require supervisors to have very well-developed “soft” skills, and few firm conclusions were drawn during the Training Workshop about how this assessment can be performed effectively – more work is required in this area.

To achieve these outcomes, an extensive amount of further training for supervisors will be required, in order to deliver the strengthened capabilities that will be required within the agencies. Substantial resources will be required to achieve this significant uplift in supervisory capability, over time.

There will also need to be a substantial investment by supervisory authorities in the development of supervisory policy frameworks for risk appetite and culture and in the implementation of the systems and processes required to effectively integrate the supervision of risk appetite and culture into the overall supervisory framework. These developments may be expected to take three to five years, or longer, to implement.

The recently-issued FSB consultative document “Principles for An Effective Risk Appetite Framework”, once finalised, will provide very important guidance for APEC supervisory agencies in relation to the development of risk appetite frameworks in financial institutions. Similarly, the FSB’s Supervisory Intensity and Effectiveness group (SIE) is currently doing work on risk culture and expects to issue a draft report later in 2013. Any guidance which may be provided by the SIE in relation to supervisory practices and approaches toward assessing risk culture in financial institutions should be valuable to supervisors in the APEC region.

Key Findings

Key outcomes from the training workshop include the following:

- While some jurisdictions are fairly advanced in implementing the capital and liquidity requirements of Basel II and Basel III, and others are less advanced, nevertheless all are aware of the importance of improved risk management and strengthened risk governance.
- Program participants achieved a sound understanding of the key concepts relating to risk appetite, risk culture and their supervision, primarily through the facilitated workshops. In particular, participants gained a strong appreciation of the importance of well-designed and implemented risk appetite frameworks, and other elements of effective risk governance arrangements, to help ensure that financial institutions do not take excessive levels of risk across the complete economic cycle, especially during economic booms.
- However, while noting the importance of effective risk appetite frameworks in enhancing financial stability, supervisors in the region have considerable work to do to educate and prepare both themselves and the financial institutions they supervise for the complex processes involved in the implementation of such frameworks.
- A strong understanding emerged for program participants that the integrated risk profile of a large financial institution is fundamentally opaque, and difficult to understand, for insiders as well as outsiders – especially in very volatile times. This makes effective risk management and risk governance very challenging.
- To successfully address and overcome this opacity of risk, a key theme of the training program was that risks are ultimately well-understood within an organisation, and acted upon, through dialogue. Thus, effective dialogue about risks at every level of the organisation is essential to ensure that risk management processes are effective.
 - Such open and effective dialogue about risks is a key characteristic of a strong risk culture; in this context, program participants achieved a strong appreciation of the importance of risk culture within the organisation as a key driver of risk management effectiveness. The participants also gained an appreciation of the challenges faced by firms to create an internal environment which facilitates and supports such a dialogue, and to create a strong risk culture, more generally.
- Participants gained an understanding of the key elements required for effective supervision of risk appetite and risk culture, including the need for a supervision policy framework that identifies and articulates the objectives and scope of supervision of risk appetite and culture, and the need for guidance to supervised entities on supervisory expectations.
 - They also developed an appreciation for the importance of integrating the supervision of risk appetite and culture into the broader supervision of risk management and risk governance, including through the use of on-site supervision and the regular interaction with institutions' boards.

- Participants concluded that there are many important benefits and outcomes to be gained by financial institutions – and especially, emerging market banks - actively engaging in the risk appetite process, beyond simply producing the final Risk Appetite Statement (RAS) itself. Examples of these benefits include:
 - Opportunity for more active engagement of directors with risk, and increased Board dialogue, ownership and accountability for risks;
 - Increased understanding of risks by all participants in the risk appetite process, including risks associated with the business model and strategy, and the risks associated with business plans and growth;
 - Prioritised, progressive strengthening of risk management tools and systems, over time, as specific gaps and weaknesses are identified through the risk appetite process;
 - Stronger risk culture; and
 - Increased ownership of risks and accountability for risk by business units.
- There was a diversity of views regarding whether it is desirable for supervisors to be prescriptive regarding the specific content of the RAS.
 - Developed country views (for example, as reflected by the case study presenters) may be generally against this, preferring to leave it to each institution to develop and evolve the content of its RAS over time.
 - However, participants in this forum saw that it would be valuable, and perhaps even necessary, for supervisors to provide at least some guidance to supervised firms on the desired contents of the RAS. This is due to concerns that many institutions within developing economies may not be able to produce a “good” RAS on their own.
 - Nevertheless, participants expressed the clear view that, rather than requiring specific RAS elements, such supervisory guidance should be principles-based, not prescriptive, and supervisors should ensure that the development of the RAS should not be reduced to a mere regulatory compliance exercise. Otherwise, the wider benefits to be gained from firms’ active engagement in the risk appetite process may be lost.
- There was a discussion of some of the special challenges for effective risk governance and associated problems for supervisors who are working in jurisdictions where major banks are predominantly family-owned or controlled, and where owners have a pervading influence over risks that a bank may take. This may or may not be a major problem in ensuring system stability, but it is one that requires the attention of governments and regulators.
- A clear outcome from the Training Workshop was that the supervisors and the institutions they supervise are on a journey that will require deeper attention (and resources) over the next five to seven years and beyond to improve risk management

and governance. Nonetheless there must be a wider appreciation within the APEC region that the journey is complex and must be viewed as an urgent priority, if the region is to ensure financial system stability in the decades ahead.

Report of the Training Workshop

Introduction

In the years since the global financial crisis, international standard-setting bodies including the Basel Committee on Banking Supervision (BCBS) and national regulatory authorities have taken a number of major initiatives to strengthen the global regulatory framework for banks and other financial institutions. Additionally, supervisors have sought to strengthen the oversight of financial institutions, in order to better prevent their failure and to increase the resilience of financial systems. Supervisory expectations for financial firms' risk management functions and overall risk governance frameworks are increasing, as post-crisis reviews by both industry and the official sector showed that this was an area that exhibited significant weaknesses in many large financial institutions during the crisis.

An effective risk appetite framework, together with a strong “*risk culture*”, provides the foundation of good risk management in a financial institution. However, the Supervisory Intensity and Effectiveness group (SIE) of the Financial Stability Board (FSB) noted in its October 2011 progress report on enhanced supervision that effective risk appetite frameworks (RAFs) that are actionable and measurable have not yet been widely adopted. It concluded that the development of an effective risk appetite framework is important for both firms and supervisors. The report also recommended that supervisors should discuss expectations for what a “good” risk appetite framework should entail, and how to supervise against these expectations.

Furthermore, in its subsequent November 2012 report,² the SIE noted that the absence of risk appetite frameworks in financial institutions that are actionable and measurable “... *has hindered the ability for senior management to instil a strong risk culture across the spectrum of staff as the articulation of the financial institution's risk appetite and risk culture are mutually reinforcing.*”

In this context, the purpose of the Training Workshop was to enhance the capacity of supervisors of banks and other financial institutions from emerging economies within the APEC region to ensure the implementation of sound risk appetite frameworks in these institutions.

More specifically, the Workshop was designed to inform the way in which supervisors ought to approach the development and implementation of effective risk appetite frameworks in the financial institutions they supervise, within the broader objective of strengthening risk governance.

It began by providing the participants with a comprehensive grounding in the relevant fundamental concepts, including the roles of financial institution boards and senior management in developing and implementing effective risk appetite frameworks and

² Financial Stability Board, (2012), “*Intensity and Effectiveness of SIFI Supervision*”, Progress report on implementing the recommendations on enhanced supervision:

http://www.financialstabilityboard.org/publications/r_121031ab.pdf

ensuring a strong risk culture. Subsequently, the program also addressed issues and challenges related to risk data aggregation, the quality and timeliness of risk information in large banks and general supervisory considerations for effective risk governance, including governance arrangements for effective risk management and the challenges for supervisors to assess risk culture in financial institutions. The sessions and materials were primarily focused on banks, but were also applicable more generally to other financial institutions and groups, including insurance companies and financial conglomerates.

The principal program objectives were as follows:

- Enable supervisors to understand good practices for the development and implementation of risk appetite frameworks in financial institutions and the associated supervisory approaches, as well as supervisory approaches to assessing the effectiveness of financial institutions' risk management and governance processes;
- Provide a platform for the exchange of information on good practice risk management and governance in financial institutions between regional policymakers and supervisors, and between officials and industry representatives; and
- Contribute to enhancing cross-border regulatory and supervisory relationships, a necessary component of regional integration.

This report begins with some background information, followed by an overview of the Training Workshop structure. This is followed by a discussion of selected highlights from the programme discussions and workshop outcomes. The report concludes with a summary of the key program outcomes and some recommendations for future capacity-building initiatives within the region.

Background

The global financial crisis revealed that, as a result of the chase for growth in the years immediately prior to the crisis, many large banks took far too much risk, in aggregate. Careful analysis has shown that much of their risk-taking was either substantially underestimated and/or misunderstood, or the subject of insufficient attention and control. And in some extreme cases, risk-taking was even unconscious.

Subsequent reviews conducted by both supervisors and various industry bodies^{3 4} confirmed that, prior to the crisis, the largest and most affected banks failed to determine and put in place appropriate boundaries for their risk-taking activities in advance, and then stick to them.

This widespread failure of large banks to define their “*risk appetite*” – essentially, the amount and type of risk that a bank is able and willing to assume in pursuit of its business

³ Senior Supervisors Group, (2009), “*Risk Management Lessons from the Global Banking Crisis of 2008*,” <http://www.sec.gov/news/press/2009/report102109.pdf>

Senior Supervisors Group, (2010), “*Observations on Developments in Risk Appetite Frameworks and IT Infrastructure*,” <http://www.newyorkfed.org/newsevents/news/banking/2010/an101223.pdf>

⁴ Institute of International Finance, (2011), “*Implementing robust risk appetite frameworks to strengthen financial institutions*,” <http://www.iif.com/regulatory/article+968.php>

objectives – and then conduct their operations within that boundary of acceptable levels of risk, was at the heart of the systemic failures of risk governance and risk management which were evident in – and contributed to – the crisis.

An additional factor also played a crucial role in these failures – institutional culture. An industry report issued during the early stages of the crisis by the Institute of International Finance⁵ first identified the crucial role played by banks’ culture as an important determinant of the effectiveness of their risk management processes, and risk governance.

More specifically, an organisation’s “*risk culture*” can be defined as “*the norms and traditions of behaviour within the organisation which shape and determine the way that employees in the organisation think about, discuss, understand and (ultimately) act upon the risks that the organisation confronts, and the risks that it takes.*”⁶ More simply, risk culture can be thought of as referring to the way in which the organisation understands, discusses and acts upon risks. Risk culture manifests itself in many ways, including the frequency and quality of the internal dialogue about risks and the organisation’s respect for risk management.

More than five years after the initial onset of the crisis, it is now a point of broad consensus across the industry and supervisors that a strong risk culture is an essential requirement to underpin the effectiveness of banks’ risk management processes and risk governance, and conversely, that a weak risk culture will serve to undermine and weaken those same processes.

In recent years, much work has been done by both the industry and the supervisory agencies to study the topics of risk appetite and risk culture, both of which are complex but essential elements of effective risk governance.

In some of the major developed markets, including Australia and Canada, large banks began developing and implementing risk appetite frameworks as early as 2008. A great deal was learned from those early efforts about the key challenges for risk appetite and how these can be addressed. A short, high-level summary of key findings and selected reports by the global financial services industry in the areas of risk appetite and risk culture (including early lessons learned and examples of emerging industry practices) can be found in Appendix 1.

The initial supervisory emphasis on risk appetite was provided by the Senior Supervisors’ Group in its reports of 2009 and 2010 referred to previously. Subsequently, as mentioned in the introduction, the October 2011 progress report by the SIE noted that effective risk appetite frameworks (RAFs) have not yet been widely adopted. This report also made some initial references to risk culture. The report also recommended that the FSB should conduct a thematic review of risk governance.

Subsequently, in its November 2012 progress report on enhanced supervision, the SIE discussed the linkage between risk appetite and risk culture, and noted that “... *the articulation of the financial institution’s risk appetite and risk culture are mutually*

⁵ Institute of International Finance, (2008), “*Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations*,” <http://www.iif.com/press/press+75.php>

⁶ Institute of International Finance, (2009), “*Reform in the Financial Services Industry: Strengthening Practices for a More Stable System*,” Appendix III, <http://www.iif.com/press/press+125.php>

re-enforcing.” The SIE also recommended that “*supervisors should further explore ways to formally assess risk culture, particularly at Global Systemically Important Financial Institutions (G-SIFIs)*”, and indicated that in the future it will discuss supervisory practices and approaches toward assessing risk culture. The SIE also stated that “*assessing the effectiveness of supervision remains a challenge.*”

In February 2013, the FSB published a “*Thematic Review of Risk Governance*” practices.⁷ The Review was initiated at the behest of the October 2011 FSB SIE progress report on enhanced supervision which noted that while much progress had been made in corporate governance since the financial crisis, risk management functions were still not considered strong and more intensive supervisory review of corporate governance, particularly risk governance, was necessary. The key conclusions and recommendations from this report were presented and discussed on the last day of the Training Workshop, and are summarised in this report.

More recently, in July 2013 the FSB released an important consultative document titled “*Principles for An Effective Risk Appetite Framework*”⁸ with responses due by end-September 2013. The Principles are intended to enhance supervisory oversight of financial institutions by establishing minimum expectations for the key elements contained in an effective Risk Appetite Framework, such as: an actionable risk appetite statement; quantitative risk limits; and clearly defined roles and responsibilities of the board of directors, senior management and business lines. The Principles also aim to establish a common nomenclature for terms used in the Risk Appetite Framework, which will help to facilitate a common understanding between supervisors and firms and to narrow any gaps between supervisory expectations and firms’ practices.

At the same time, the third annual high-level symposium on supervision was hosted by the Federal Reserve Bank of New York in July 2013. The symposium was principally focussed on risk culture, supervision and risk governance.

To summarise, both risk appetite and risk culture are complex topics which have risen to prominence in recent years since the financial crisis as central underpinnings of effective risk management and governance, and which are currently receiving substantial and increasing attention from both the official sector and industry. Over the last two to three years the largest banks in many economies across the globe have begun working very intensively to define and implement risk appetite, and to diagnose and strengthen their risk cultures. Both topics are relatively new and quite challenging for senior management, boards and supervisors of financial institutions in most jurisdictions, and much progress remains to be made in both areas.

In particular, going forward it will be essential for supervisors everywhere in both developed and emerging economies to develop a strong understanding of both topics, and for relevant supervisory agencies to develop appropriate approaches to the assessment and supervision of both risk appetite frameworks and risk culture in banks and other financial institutions, within the broader risk governance context. As is clear from the 2012 SIE report, with few

⁷ Financial Stability Board, (2013), “*Thematic Review on Risk Governance*”, http://www.financialstabilityboard.org/publications/r_130212.pdf

⁸ Financial Stability Board, (2013), “*Principles for An Effective Risk Appetite Framework*,” http://www.financialstabilityboard.org/publications/r_130717.htm

exceptions such approaches are mostly in their infancy today. This is especially the case in the developing economies within the APEC region.

The Training Workshop was developed specifically to explore and discuss the key challenges that supervisors will face as they seek to develop and implement such approaches.

Program Overview

The four-day training workshop in Shanghai was jointly organised by the Australian APEC Study Centre at RMIT University and the Asia-Pacific Finance and Development Centre (AFDC), Shanghai, and was funded by APEC.

The detailed program of sessions for the Training Workshop was developed over several months and benefitted greatly from comments and specific suggestions received from representatives from APRA, the Senior Supervisors' Group, the World Bank, the Supervisory Intensity and Effectiveness group of the FSB, and the Federal Reserve Bank of New York, among others. This input is gratefully acknowledged.

Thirteen participants attended the program from 7 APEC member economies: China, Malaysia, Mexico, Chile, Philippines, Thailand and Vietnam. The program was coordinated by Mark Lawrence with support from Geof Mortlock and Ken Waller, including assistance from the Australian APEC Study Centre and AFDC, Shanghai.

The program brought together supervisors, industry participants and specialists in the area of risk management and governance, and was effectively split into two distinct phases. (For the complete list of presenters, please see the detailed workshop program which is attached as Appendix 2.)

Phase one of the program consisted of an introduction and extensive analysis and discussion of the concepts of risk appetite and risk culture, the relationship between these two concepts, and their central role in effective risk governance in large financial institutions. The discussions in phase one highlighted the complex challenges that large banks and other financial institutions face in seeking to develop and implement risk appetite frameworks, including:

- How to effectively express risk appetite (including what metrics to use, and how to capture risks which are not easily quantified);
- How to directly link risk appetite with business strategy and planning processes, to ensure coherence and alignment between these; and
- How to cascade risk appetite effectively throughout the firm and link it to daily operational decision-making.

This phase commenced with several introductory presentations relating to risk appetite, risk culture and risk governance more generally, which laid a foundation of shared understanding of these key concepts necessary for the subsequent discussions.

Following these introductory presentations, participants received two detailed case study presentations, from Commonwealth Bank of Australia (CBA) and DBS in Singapore, explaining in some detail the approaches that were taken by these two leading large banks in

the APEC region to the design, implementation and evolution of their RAFs over several years. Harrison Young provided many unique insights and perspectives on the risk appetite process at CBA from a Board Director's perspective, while Elbert Pattijn provided a quite different perspective – that of the Chief Risk Officer (CRO), from within the management team – on the risk appetite process at DBS. Both case study presenters highlighted the challenges associated with the development and implementation of the RAF at their respective institutions, and provided clear motivation for the two very different approaches which were taken to RAF design and implementation at these two leading banks.

The two case studies were followed by three facilitated workshops for the participants.

In the first workshop, participants substantially deepened their understanding of the difficulties and challenges that banks face to define their risk appetite, by exploring these challenges in detail from the perspective of several different internal stakeholders within the bank, including the board and senior management team. This enabled the participants to effectively “walk a mile in the shoes” of the bankers that they supervise, in attempting to grapple with the complex challenges of risk appetite.

In the second facilitated workshop, participants worked to identify the most important outcomes of the risk appetite process for banks and other financial institutions in emerging markets.

In the third facilitated workshop, participants considered the contents of the Risk Appetite Statement (RAS) in detail, focussing on several key questions of particular interest to supervisors, including:

- Is it possible to identify some of the specific elements that should be contained within a good RAS for a large bank?
- If so, what would these elements be for a bank in an emerging market?
- Is it *desirable* to try to specify the core elements of a "good" RAS - or should this question be deliberately left open and flexible, at this early stage?

Phase two of the program focussed on supervisory objectives and challenges for risk appetite. Highlights of phase 2 of the program included:

- Detailed presentations of differing supervisory approaches to risk appetite, incorporating perspectives from particular developed and developing markets within the APEC region (Australia and China);
- An expert panel discussion of the key supervisory objectives and challenges for risk appetite;
- A session dedicated to risk governance, more generally – including principal findings and recommendations from the 2013 FSB Peer Review of Risk Governance, and key insights and recommendations arising from a review of the risk governance failures which contributed to the substantial 2012 trading losses at JP Morgan; and
- An extended facilitated workshop on the way forward for supervision of risk appetite and risk culture.

The initial, detailed presentations of differing supervisory approaches to risk appetite commenced with an extensive presentation from Geof Mortlock which featured a large number of principles and specific examples drawn from the Australian Prudential Regulation Authority (APRA) and other developed markets, relating to the relevance of risk appetite and culture to the prudential supervisor; how the supervision of risk appetite fits into the overall framework for risk-based supervision; and approaches to the supervision of risk appetite and risk governance.

The presentation by Luo Ping from the China Banking Regulatory Commission (CBRC) described recent progress with respect to the implementation of risk appetite in large Chinese banks. Luo's presentation explained that until now, the risk appetite for these banks has been largely determined by the supervisor for prudential or other reasons, and highlighted the likely evolution towards a greater role for banks in the determination of their risk appetite in the future.

These two detailed presentations served to both illustrate the wide diversity of approaches to risk appetite which have emerged within the region in recent years, and also to "set the scene" for the subsequent discussions.

The participants in the panel discussion of the key supervisory objectives and challenges for risk appetite addressed some core questions relating to the supervision of risk appetite which are of fundamental importance for supervisors, including:

- What are the supervisory processes required to ensure that financial institutions develop and implement effective Risk Appetite Frameworks?
- What guidance – if any – should supervisors provide to financial firms about how they should determine their risk appetite?
- How important is it for supervisors to look beyond the Risk Appetite Statement itself, to an examination of a firm's underlying risk appetite processes?
- How can supervisors effectively monitor whether firms are making adequate progress in risk appetite?
- How can supervisors assess the effectiveness of firms' risk appetite processes, over time?
- How can supervisors assess and understand the strengths and weaknesses of the risk culture within a firm?

The final day of the program commenced with a session dedicated to risk governance. An excellent summary of one (developed market) supervisor's perspective on the importance of strong risk governance can be found in the February 2013 speech "*The Importance of Good Governance*" by APRA Chairman, John Laker.⁹ This speech was included within the program pre-reading for the participants.

⁹ Speech by Dr John Laker, "*The importance of good governance*," Delivered on 27 February 2013 at the Australian British Chamber of Commerce, Melbourne. <http://www.apra.gov.au/Speeches/Pages/The-importance-of-good-governance.aspx>

The Training Program session dedicated to risk governance commenced with a presentation from Laura Ard, from the World Bank, on the February 2013 FSB Thematic Review on Risk Governance. Laura's presentation highlighted progress made by firms in strengthening certain aspects of risk governance since the crisis and progress made by supervisors to develop or strengthen guidance on risk management and oversight responsibilities, and to elevate supervisory expectations for more rigorous risk management. The presentation also identified a number of key issues for firms and supervisors. Finally, the results of the work that the World Bank has conducted on corporate governance in its client economies were also compared to the findings of the FSB Review and several interesting, high level observations were drawn.

Laura's presentation was followed by a presentation by James Hennessy, of the Federal Reserve Bank of New York, on the key findings and recommendations relating to risk governance arising from the report of an independent investigation into the losses in JP Morgan Chase's CIO office (the "London Whale" losses). The presentation highlighted key findings from the report in the areas of the responsibilities of the Board Risk Committee, the nature of the risk information that should be reported to that committee, and the nature of the dialogue between senior management and supervisors.

Finally, James highlighted a recent shift at the Federal Reserve Bank of New York towards enhanced engagement with directors and senior management by supervisors, as a key part of the New York Fed's new approach to supervision over the past two years. This enhanced engagement includes the objectives of developing a more real-time, forthright dialogue and increased levels of trust between institutions and supervisors.

The program concluded with an extended facilitated workshop for the participants on the supervision of risk appetite and risk culture. In the workshop, the participants split into three groups and considered a range of topics, including:

- The linkage of risk appetite statements to the supervisory objectives of promoting sound financial institutions and financial systems;
- The design of supervision policy on risk appetite and culture, including policy objectives and the nature of guidance that should be provided to regulated entities; and
- The implementation of the supervision process in relation to risk appetite and risk culture, including its integration into broader supervisory objectives, and the kind of staff skills that are needed to perform the supervision of risk appetite and risk culture.

Selected highlights from program discussions and workshop outcomes

The detailed schedule and content of the program sessions is attached as Attachment 2. In this section of the report we highlight some of the key topics discussed and selected key outcomes from the discussions.

Risk appetite

The case studies of the implementation of risk appetite in two large banks within the APEC region provided two very different perspectives on the implementation challenges – that of the CRO (DBS) and that of the Chairman of the Board Risk Management Committee (Commonwealth Bank of Australia). Although the risk appetite frameworks in the two banks

look somewhat different, both banks commenced their development and implementation of risk appetite several years ago, on their own initiative (i.e., not in response to a supervisory demand). The presenters shared many common perspectives on the risk appetite implementation process and challenges.

Some highlights and key points from the two case study presentations included:

- RAF development and implementation is a very long and difficult journey, and is iterative in nature.
- Both presenters agreed that the specific contents of the RAS may be less important than the iterative process of creating and refreshing it: *“the risk appetite process itself is more important than the document produced”* and *“the journey of risk appetite may be more important than the destination”*.
- Fundamental importance of having a strong risk culture to make risk appetite effective.
- RAF development process led by the CRO in an iterative process with the Board worked well in the two case study banks.
- The risk appetite conversation should begin with a discussion of the risks in the business model – a succinct description of the business model is a good way to surface the risks.
- Board directors have different views about acceptable levels of risk in different areas, and it is necessary in the risk appetite process to understand this difference of views and to reconcile them through an iterative set of board discussions, over time.
- Risk appetite is strongly linked to risk culture, and it can be very helpful to make this link explicit by including a section on risk culture within the RAS, potentially including desired behaviours with respect to risk.
- Risk appetite is a boundary for risk-taking, not a target level of risk.
- A workable RAS should include both qualitative and quantitative statements. Both are valuable.
- Important dimensions of risk appetite may include identifying preferences and tolerances for different growth rates in different business lines (for example, the desire for caution in entering a new business, while understanding and capability are built), the speed at which new initiatives are undertaken, and constraints on the number of major projects that can be undertaken simultaneously, in recognition of the fact that management bandwidth is limited.
- Risk must be owned by the business.
- Risk appetite and strategy must be aligned; neither should be discussed without reference to the other.
- Identification of risks is more important than quantification - if you put too much emphasis on measuring risk, you will tend to ignore the risks that are hard to measure.

- Some comments from the presenters about the role of supervisors in the risk appetite process:
 - *“Regulators and supervisors should not be too prescriptive about risk appetite; all they should require is that boards meaningfully engage with the topic.”*
 - *“Supervisors can assist the risk appetite process by providing a directional push, but must understand that the development process takes time”*

These comments are very consistent with the perspectives and recommendations from earlier industry studies of risk appetite (see Appendix I).

Some key conclusions from the facilitated workshops about risk appetite included:

- The starting point and nature of the risk appetite process is somewhat shaped by the business model and current capabilities in risk management of the institution.
 - Firms with already sophisticated systems and risk management processes, well-developed and credible risk measures and reports and strong risk governance, may take a wide-ranging, comprehensive and detailed approach in the early stages, perhaps similar to one of the case study approaches.
 - Conversely, firms which lack such capabilities may need to take a simpler, more principles-based approach to risk appetite, relying on fewer risk metrics at the start. Indeed, for these firms the risk appetite process can act as a catalyst for the strengthening of these capabilities.
- Participants identified many important benefits and outcomes to be gained by financial institutions – and especially, emerging market banks – actively engaging in the risk appetite process, beyond simply the final RAS itself. Examples of these benefits include:
 - Opportunity for more active engagement of directors with risk, and increased Board dialogue, ownership and accountability for risks
 - Increased understanding of risks by all participants in the risk appetite process, including risks associated with the business model and strategy, and the risks associated with business plans and growth
 - Clearer understanding and the boundaries of acceptable risks throughout the firm
 - Strengthening of risk management tools and systems, over time, as specific gaps and weaknesses are identified through the risk appetite process
 - The risk appetite process is dialogue-intensive, and strengthens the risk culture
 - Increased ownership of risks and accountability for risk by business units
 - Strengthened internal communication channels and feedback mechanisms
- There was a diversity of views regarding whether it is desirable for supervisors to be prescriptive regarding the specific content of the RAS. However, participants felt that supervisors in emerging markets may find it necessary and desirable to provide detailed

guidance regarding the risk appetite process and contents of the RAS to their banks, given that their risk management capabilities may not be strong. In such cases, supervisory guidance should be principles-based, not prescriptive.

Risk culture

The definition and key features of a strong risk culture were identified during phase one of the Training Workshop, together with typical risk culture weaknesses that were observed in the lead-up to, and during, the crisis.

The central elements of an effective risk culture include:

- i) Business unit “ownership” of their risks
- ii) Horizontal information sharing across businesses and central functions
- iii) Rapid vertical escalation of threats or fears
- iv) Routine, open and informed discussion about risks at every level of the organisation
- v) Continuous and constructive challenging of the organization’s actions and preconceptions
- vi) Committed leadership
- vii) Incentives that reward thinking about the whole organization

Multiple weaknesses in risk culture have been observed in many firms which experienced difficulty, and these have been extensively analysed.¹⁰ One of the most pervasive of these weaknesses, is that in many financial institutions, junior staff are too afraid or concerned to raise issues or problems which concern them, for fear of being blamed, or looking bad (or stupid) – in other words, crucial “bad news” frequently does not travel upwards in a timely manner, to the level where it needs to, in order for the appropriate response to be taken by senior management. This failure of threats or fears to be reliably escalated is widespread and undermines risk management effectiveness in many financial institutions.

Therefore, to establish an effective risk culture, among other things it is essential for firms to create an environment in which all employees feel safe to raise risk issues and to question, challenge and ultimately escalate (if necessary) things that they don’t understand or which look unusual to them. Through extensive discussion in the Workshop, this was widely understood to be a very difficult task, especially for junior staff.

As highlighted in the Executive Summary, the Workshop participants realised that it will be very challenging for supervisors to assess the risk culture within the firms that they supervise, although it will be very important to make this assessment; performing this assessment will require supervisors to have very well-developed “soft” skills, and few firm conclusions were drawn about how this assessment can be performed effectively – more work is required in this area.

¹⁰ See footnote 6.

Risk Governance

Since the crisis, a great deal of work has been done with the objective of strengthening risk governance.¹¹ The Training Workshop session dedicated to risk governance featured a presentation from Laura Ard, from the World Bank, on the February 2013 FSB Thematic Review on Risk Governance. Some key findings from the Thematic Review regarding progress in risk governance include:

- In general, firms in regions which were hardest hit by the crisis have made the most progress in strengthening risk governance; in some jurisdictions they are ahead of regulatory requirements.
- More specifically, firms have made strides in evaluating the board and board functions. They have assessed both the collective qualifications and effectiveness of the board and have made progress in strengthening board composition. Firms are increasingly making use of self-evaluations and third parties to assess board effectiveness.
- Firms have established board-level risk committees, increasingly with only independent board members and with a clear definition of independence.
- Group-wide CROs and risk management functions have been established that are independent from revenue generating responsibilities and having the authority and stature necessary to challenge risk decisions made by management.
- Most supervisors have developed or strengthened regulation and/or guidance on risk management and oversight responsibilities; supervisory expectations for more rigorous risk management have been elevated
- Supervisors are more actively evaluating risk management through several means, including more frequent dialogue with boards and management, more rigorous assessment of oversight functions and through assessing the adequacy and accuracy of board risk information.

Some key issues and challenges which were identified in the Thematic Review include:

- Supervisory authorities do not engage frequently enough with boards, or their risk and audit committees, and no jurisdiction has specific expectations for internal audit to perform firm-wide assessments of risk management and governance.
- The role of the CRO needs further elevation and support by the Board risk committee through performance reviews, objective setting, and fluid access to the risk committee and board.
- Board risk committees need more developed objectives and procedures.
- More work is required, by supervisors and firms alike, on establishing integrated and effective risk appetite frameworks

¹¹ Chapter 3 of the report by the Group of Thirty: *“Toward Effective Governance of Financial Institutions”*, April 2012, contains an insightful discussion of risk governance and eight specific recommendations for boards and management of financial institutions to strengthen risk governance.

The results of the work that the World Bank has conducted on corporate governance in its client economies were also compared to the findings of the FSB Review. Several interesting, high-level observations were made; highlights include the following:

- Many banks in World Bank client economies lack objective boards and clear separation of the important board oversight, management, and ownership roles. This is due, in large part, to strong controlling ownership of many banks, its heavy representation on the board(s), and therefore, much of the time, its influence within management. In many cases, controlling ownership representation on the board negatively impacts the board's capability, or recognition of the need for, strong, objective risk governance and “arm's length” dealings.
- There is a need to diversify board membership in a number of instances to ensure the right mix of skills, including critically, skills in risk management.
- Board performance evaluations (either self-evaluations or evaluations undertaken by third parties) are just now beginning to be considered and should continue to be encouraged as a means, in part, to address the above issues of board objectivity, composition, and skill sets.
- With gradual diversification of board membership, boards should be better able to execute stronger risk governance, including ensuring that risk appetite becomes a critical part of the strategic planning process.
- Risk management functions are consistently under-resourced, especially in light of the complexity of and risks run by the subject bank(s). As well, the CRO rarely has input into the strategic planning processes of most banks. Very few, if any, independent assessments of risk governance or risk appetite frameworks have been conducted.

From the Training Workshop discussions, many of these points have relevance to banks and supervisors in the participating APEC economies.

Supervisory objectives and approaches to risk appetite and risk culture

In the final, extended facilitated workshop, the participants split into three groups and considered in detail a range of topics relating to supervisory objectives and approaches to risk appetite and risk culture, as indicated in the Program Overview. Importantly, many of the conclusions reached in these small group discussions were of a very preliminary and tentative nature, and were not extensively discussed in the full group of participants subsequently, due to time constraints; accordingly, much further discussion of these topics is recommended. Indeed, the presence in the Training Workshop of a larger number of more senior supervisors with substantial, front-line supervisory experience would have substantially enhanced these discussions.

In addition to the points highlighted in Key Findings, some key outcomes from these discussions included:

- To ensure effective supervision of risk appetite and risk culture, supervisors will need to have a range of skills and knowledge, including:
 - A comprehensive understanding of both risks and risk-based supervision
 - Highly developed “soft” skills to assess and evaluate risk culture
 - The ability to understand and assess the risks associated with specific business models, in the context of supervisory evaluation of risk appetite frameworks.
- A substantial amount of further training of supervisors will be needed, in order to deliver these strengthened capabilities within the agencies.

There was an extensive discussion with the large group addressing the important question – how should supervisors get started with risk appetite? It was agreed that, once the banks and other financial institutions (as applicable) in each jurisdiction know that they need to define their risk appetite, they will very quickly seek detailed guidance from their supervisors about what exactly is required, and how they should proceed to meet the supervisory requirements in this area.

Participants also agreed that – notwithstanding that many banks in the larger developed markets have been developing and implementing risk appetite for several years already – a great deal of careful preparation will be required before commencing supervisory implementation of risk appetite in many of the participating jurisdictions, including the determination and clarification of regulatory and supervisory objectives and requirements for risk appetite, and the strengthening of supervisory capabilities. Accordingly, supervisors should begin this preparation as soon as possible, which was described during the discussions as “going on the risk appetite pre-journey”.

Some additional points raised during this discussion, include:

- Strengthen in-house training within supervisory agencies.
- See what other agencies are doing – exchange ideas and learn from each other’s experience with risk appetite.
- Initial steps should involve examining risks in the business model, looking into risk culture and focusing on basic risk appetite principles.
- *Be realistic about timing* – implementing risk appetite within most of the participating jurisdictions is a journey which will take five years or longer.
 - Experience elsewhere has shown that there is a great deal of “learning by doing” when it comes to developing and implementing risk appetite, but the benefits are very substantial.

Conclusion and Recommendations

As stated previously, both risk appetite and risk culture are essential pillars of effective risk governance in financial institutions. Both are very complex topics which are currently receiving very substantial and increasing attention from the official sector (including the Financial Stability Board and its Supervisory Intensity and Effectiveness group) and industry. Both topics are relatively new and challenging for bank senior management, boards and supervisors in most jurisdictions, and much progress remains to be made in both areas.

The discussions in the training program confirmed and reinforced this view within the region. The discussions revealed that the development and implementation of risk appetite frameworks is still in its infancy in the financial systems of most of the participating APEC economies. In particular, in most participating economies few (if any) major banks or other financial institutions have made substantial progress in developing and implementing an effective risk appetite framework, and in some economies, little work has been done. The issue of risk culture has received even less attention in the participating economies to date, if any.

Furthermore, most Workshop participants had received little – if any – personal exposure to the central concepts of risk appetite and risk culture, prior to attending the program.

In this context, the Workshop program design and content may be seen to be quite ambitious for a four-day program, in retrospect. Furthermore, the workshop could have also benefitted from participation by more senior front-line supervisors with a high-level executive perspective on the issues discussed. Nevertheless, the program discussions were of a uniformly high-quality, detailed and insightful. Each day's discussions built effectively upon the insights drawn from the discussions of the previous days, and the level of active engagement by the participants was very high.

- The principal conclusion from the program is that, as a group, the participating agencies within the region have a very large distance to travel in order to achieve a strong foundation of deep and widespread knowledge and understanding of the key concepts of risk appetite and risk culture throughout their agencies, and to subsequently design and implement new or enhanced supervisory practices which embed these concepts and fully reflect such understanding.
- Such deep and widespread knowledge and understanding of these fundamental concepts, and appropriately redesigned and enhanced supervisory practices will take substantial time to achieve. Nevertheless, these outcomes are essential in order to strengthen risk governance in financial institutions and strengthen the resilience of financial systems throughout the APEC region.
- To achieve such an outcome, an extensive amount of further training for supervisors, especially senior supervisors, will be required in order to deliver the strengthened capabilities that will be required within the agencies. Substantial resources will be required to achieve this significant uplift in supervisory capability, over time.
- The recently-issued FSB consultative document titled, *Principles for An Effective Risk Appetite Framework*, once finalised, will provide very important guidance for APEC supervisors in relation to the development and supervision of risk appetite frameworks in financial institutions. Similarly, prospective guidance from the FSB's

SIE group in relation to supervisory practices and approaches toward assessing risk culture in financial institutions, which is expected to be forthcoming in the near future, should be extremely valuable to supervisors in the APEC region.

The discussions and outcomes from this Training Workshop underscored that a substantial amount of work is required to strengthen risk governance in financial institutions and to build the corresponding supervisory capabilities and approaches within the participating APEC economies.

Recommendations

At the conclusion of the Training Workshop, it was noted that a number of initiatives are likely to be required in order to foster effective supervision of risk appetite and culture in financial institutions across the APEC region. Some of these initiatives lie within the supervisory authorities themselves, while others might appropriately be taken forward by international and regional bodies.

In the case of international standard-setting bodies, such as the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors and the Financial Stability Board, there would be value in developing more guidance for supervisors on the supervision of risk appetite and culture, including in respect of the techniques that supervisors can use to effectively supervise financial institutions in these areas, and the means of integrating risk appetite/culture supervision into the wider supervision process.

In the case of the Financial Stability Institute, World Bank, regional development banks and regional supervisory bodies (such as EMEAP), there would be value in developing training for supervisors on risk appetite and culture issues, including guidance on the technical elements of risk appetite statements and how these are integrated into the risk management framework, governance and the supervisory techniques applicable in these areas.

In the case of the supervisory agencies themselves, the development of supervisory arrangements for risk appetite and culture will need to be determined having regard to their overall supervisory objectives, priorities and the stage of development of their financial institutions and systems. There is no “one size fits all” approach. However, the development of supervision of risk appetite and culture will likely need to include the following elements:

- Development of the policy objectives in relation to the supervision of risk appetite and culture – clarity of objectives is essential to the effective development of supervision policy and the achievement of the desired outcomes.
- Development of proposed policy and prudential requirements for risk appetite and culture, as a basis for consultation with affected stakeholders, principally the relevant financial institutions, their boards, management and auditors. This would include the proposed extent and nature of any requirements and guidance on risk appetite statements and culture, associated governance arrangements, and the regulatory obligations of directors, CRO, internal audit and external audit, if/as applicable.¹²

¹² As an example of such a policy, in May 2013 APRA issued a draft new prudential standard for risk management, CPS 220 ([http://www.apra.gov.au/CrossIndustry/Consultations/Documents/Level-3-Draft-Prudential-Standard-CPS-220-Risk-Management-\(May-2013\).pdf](http://www.apra.gov.au/CrossIndustry/Consultations/Documents/Level-3-Draft-Prudential-Standard-CPS-220-Risk-Management-(May-2013).pdf)). The draft standard contains numerous specific requirements for risk governance, including requirements relating to the role of the board, the elements

- Development of the framework for supervising risk appetite and culture, including the nature and extent of off-site and on-site supervision, interaction with the boards and risk management committees of financial institutions, and integration of risk appetite supervision with the wider supervisory arrangements, if/as applicable.
- Development of ongoing training programs for officials in supervisory agencies to build capacity on risk appetite and culture issues, and associated governance, is important. In that respect, training programs designed to engage senior supervisors to incorporate key concepts of risk appetite, culture and governance into their supervisory functions and management roles will be particularly beneficial.
 - Furthermore, developing a program of periodic staff secondments of mid-level supervisory staff to financial institutions and recruitment of risk specialists to the supervisory agency, if/as applicable, will also be beneficial.

It is recommended that the development of these elements of the supervisory arrangements for risk appetite and culture be afforded the highest priority within the supervisory agencies across the APEC region, going forward.

of the risk management framework, role of the CRO and specific requirements for risk appetite. The standard is comprehensive in its approach, i.e., it applies to the regulated entity itself, its group, and (where applicable) the entire conglomerate group. For risk culture, the draft prudential standard is less specific – it requires that: “... *the Board must ensure that... a sound risk management culture is established and maintained throughout the institution...*” and the organisation must maintain a Risk Management Strategy document which (among other things) “... *outlines the approach for instilling an appropriate risk culture across the institution.*” In a recent speech (<http://www.apra.gov.au/Speeches/Documents/Ian-Laughlin-IAA-20-May-2013.pdf>), APRA clarified their intended approach to forming a view of the quality of an institution’s risk governance and its risk culture: “... *To help with this, we plan to enhance our interaction with boards... We intend to rely heavily on the board’s own assessments of both risk governance and risk culture, and so will be strongly encouraging boards to form firm views and understanding of each...*”

Appendix 1: Selected industry initiatives and key findings on Risk Appetite and Risk Culture

This appendix contains a high-level summary of selected reports and key findings by the global financial services industry in the areas of risk appetite and risk culture. This short, “highlights” list is very far from complete, however it covers most of the key industry reports and findings which were presented and discussed in phase one of the Training Workshop.

The need for large banks to define and embed their risk appetite within their business operations was identified as a key issue and priority very early during the financial crisis, by both major bank supervisors and the industry.¹³

Nevertheless, at least until the end of 2010 there existed some doubt, and even a degree of scepticism, about whether it is even possible for large and complex financial institutions to “do” risk appetite effectively, at all, as there were very few examples of large banks which had made substantial progress with risk appetite, at that time.

Perhaps partly as a result of this doubt and scepticism, but largely because there was a great deal of interest in how to address and successfully overcome the large number of formidable challenges associated with defining risk appetite, a detailed investigation of leading industry practices in the area of risk appetite was conducted by the IIF in 2010-2011. In its June 2011 final report, *Implementing Robust Risk Appetite Frameworks to Strengthen Financial Institutions*, the IIF’s Steering Committee on Implementation identified the principal challenges which are faced by firms looking to develop and implement an effective risk appetite framework.

The principal challenges include how to:

- i) Effectively express risk appetite, including what metrics to use, and how to capture risks which are not easily quantified;
- ii) Directly link risk appetite with business strategy and planning processes, to ensure coherence and alignment between these;
- iii) Cascade risk appetite effectively throughout the firm – linking it to daily operational decision-making and making it relevant to front-line staff;
- iv) Ensure alignment between risk appetite at the Group and business unit levels; and
- v) Meaningfully incorporate stress testing within the RAF.

The IIF report also contained some detailed discussion about “what works” in overcoming these challenges, based upon early lessons learned from the investigation. The report contained a large number of specific, practical examples and detailed recommendations for both senior management and board directors, and a separate section discussing the implications for supervisors of the findings from the investigation.

The report also included an appendix containing the results of a global survey of industry-wide practices in the area of risk appetite which was conducted in late 2010 as part

¹³ See footnotes 3 and 5.

of the investigation and, importantly, four detailed, named case studies of large banks' implementation of risk appetite frameworks.

The principal findings from the June 2011 IIF investigation of Risk Appetite include the following:

- i) Developing a Risk Appetite framework is a multi-year, iterative “journey”, which is quite new for most firms – many of which are still in the relatively early stages;
- ii) The cultural, procedural & technical challenges involved in defining risk appetite are formidable; the process is complex, requiring interaction between Board, senior management & risk management, and a substantial amount of time and judgment;
- iii) Nevertheless, this is indeed achievable – some leading firms are making very good progress, and seeing clear benefits already, including a clearer understanding of the risk implications of strategy & business plans;
- iv) A strong Risk Culture is an essential component of, and a pre-requisite to, establishing an effective Risk Appetite framework;
- v) Risk Appetite must be tightly and formally linked to strategy development and business planning, to ensure alignment between these;
- vi) Firms have adopted a wide range of approaches in developing their Risk Appetite frameworks, reflecting their diverse business models, infrastructure, capabilities & circumstances – *one size does not fit all*; and
- vii) The degree of progress varies – a substantial gap is likely to remain for some time between emerging good practices & what is more “typical” across the industry.

Similarly, in the December 2009 report, *Reforms in the Financial Services Industry: Strengthening Industry Practices for a More Stable System*, the IIF's Risk Management Working Group (RMWG) provided a definition and detailed discussion of various aspects of risk culture, including the central elements of an effective risk culture and a list of typical risk culture weaknesses which had been evident in the crisis.

As noted previously, the central elements of an effective risk culture which were identified in the IIF report include:

- i) Business unit “ownership” of their risks
- ii) Horizontal information sharing across businesses and central functions including Finance and Risk Management
- iii) Rapid vertical escalation of threats or fears
- iv) Routine, open and informed discussion about risks at every level of the organisation
- v) Continuous and constructive challenging of the organization's actions and preconceptions
- vi) Committed leadership

vii) Incentives that reward thinking about the whole organization

Importantly, in seeking to promote and encourage effective dialogue about risks – which is an essential prerequisite for firms to be able to effectively balance risk against return on a daily basis at all levels of the organisation – the RMWG identified the common and very substantial difficulty that many large firms face to create an environment in which all employees feel safe to raise risk issues and to question or challenge things that they don't understand or which look unusual to them.

Nevertheless, in order for the risk management processes within a large organisation to be effective, it is essential that such an environment be created and that such behaviours become both routine and widespread.

Determining whether or not (and where) such an internal environment exists – and driving the necessary cultural and behavioural changes, if not – represents a very significant challenge to the senior management and boards of large banks, which has been receiving increasing attention over the past 2 – 3 years.

Bearing in mind all of the work done on risk appetite and risk culture by an increasing number of financial institutions over the last few years, in light of the current high priority attached to these topics it was felt that it could be valuable to gather together a range of practical examples of industry practices in these areas. Accordingly, a large number of additional, specific “examples of industry practice” for risk appetite, risk culture and risk governance can be found (together with a summary of key principles) in the October 2012 report by the IIF Committee on Governance and Industry Practices titled, “*Governance for Strengthened Risk Management*”.¹⁴

Nevertheless, although much work is being done and progress is being made in the areas of risk appetite and risk culture, it is clear that a great deal more remains to be done across the industry.¹⁵

¹⁴ Institute of International Finance, (2012), “*Governance For Strengthened Risk Management*,” <http://www.iif.com/press/press+364.php>

¹⁵ Ernst & Young, (2013), “*Remaking financial services: risk management five years after the crisis*,” [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](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)

Appendix 2: Shanghai Training Workshop Program

Enhancing Supervision of Financial Institutions' Risk Appetite Frameworks

Capacity Building Workshop for APEC Economies

**Organised by the Australian APEC Study Centre and Asia-Pacific Finance and
Development Center**

Sponsored by Asia-Pacific Economic Cooperation

**20 – 23 May 2013
Shanghai, China**

Introduction

This APEC-funded project will focus on enhancing the capacity of supervisors and regulators of banks and other large financial institutions to adequately ensure the implementation of sound risk appetite frameworks within regional financial sectors. The project will outline the various roles of financial institution boards and management in developing and implementing effective risk appetite frameworks, linking these directly to strategy and to day-to-day business risk management processes. It will inform the way in which supervisors ought to approach the development and implementation of effective risk appetite frameworks in the large financial institutions they supervise. It will also address issues related to data aggregation and governance arrangements for effective risk management. The sessions and materials will be primarily focused on banks, but will also be applicable more generally to other large financial institutions and groups, including insurance companies and financial conglomerates.

Objectives

- Enable supervisors to understand good practices for the development and implementation of risk appetite frameworks in financial institutions and the associated supervisory approaches, as well as supervisory approaches to assessing the effectiveness of financial institutions' risk management and governance processes.
- Provide a platform for the exchange of information on good practice risk management and governance in financial institutions between regional policymakers and supervisors, and between officials and industry representatives.
- Contribute to enhancing cross-border regulatory and supervisory relationships, a necessary component of regional integration.

Participation

The training workshop is expected to be attended by up to 13 participants from 7 APEC economies. The APEC economies are: Chile, China, Malaysia, Mexico, The Philippines, Thailand and Viet Nam.

Workshop participants will be mid- to high-level policy personnel from supervisory and regulatory agencies, such as central banks and prudential regulators, who are responsible for supervising and regulating risk management and governance standards in financial institutions in their home economies.

The Project Team

The lead consultant for this training workshop will be Dr. Mark Lawrence, and Mr. Geof Mortlock will be the co-consultant.

Dr. Mark Lawrence

Dr. Lawrence was previously the co-chairman of both the Institute of International Finance's (IIF) Risk Management Working Group and also its Working Group on Risk Appetite, which produced a substantial report in mid-2011 calling on banks to adopt robust risk appetite programs aimed at reducing the riskiness of banks and strengthening the financial sector. The report also made many specific recommendations regarding the development and implementation of effective risk appetite frameworks.

Since 2008, Dr. Lawrence has operated his own consultancy firm, Mark Lawrence Group, which advises banks, other large financial institutions and financial regulators from both developed and emerging economies such as Malaysia, Singapore and Brazil on a wide range of risk management, governance and regulatory issues, including how to develop and implement effective risk appetite frameworks.

Mr. Geof Mortlock

Geof has many years of experience in financial institution regulation and prudential supervision, including five years at the Australian Prudential Regulation Authority (2008 to 2013) and 24 years at the Reserve Bank of New Zealand (1983 to 2007). In this capacity, Geof has gained considerable experience and expertise on financial sector regulatory and supervision issues, including in respect to supervision of financial institutions' risk appetite, risk management and corporate governance arrangements. He has also worked on working groups of the Financial Stability Board and Basel Committee on Banking Supervision, participated in FSAP and TA missions for the IMF and World Bank, and organised and chaired several policy workshops in the APEC Finance Ministers process.

Mr. Nofel Wahid from the Australian APEC Study Centre at RMIT University, Australia and Mr. Scott Liu from the Asia-Pacific Finance and Development Center at Shanghai will also be in attendance to assist with administration and coordination of the program.

WORKSHOP PROGRAM

DAY ONE – Monday, 20 May 2013	
Theme: Introduction to risk appetite and risk culture	
8.45 – 9.00	Registration
9.00 – 9.30	<p>Session 1: Welcome and Orientation</p> <p>Introduction to the training program, including outline and objectives of the program and intended outcomes.</p> <p><u>Speakers</u></p> <p>Dr. Li Kouqing, Director General, Asia-Pacific Finance and Development Center Mr. Ken Waller, Director, The Australian APEC Study Centre</p>
9:30 – 10:45	<p>Session 2: The context for risk appetite; participant introductions and objectives</p> <p><u>Synopsis</u></p> <p>The session will “set the scene” for risk appetite, commencing with a brief, high-level perspective on risk appetite and risk governance, highlighting some key findings by the Senior Supervisors Group (SSG).</p> <p>Participants will then be invited to share their backgrounds and personal goals and objectives for the program. Participants will also be asked to briefly outline their supervisory authority’s initiatives to date in relation to risk appetite, and to provide an overview of industry progress in this area. The session will also include a Q&A discussion.</p> <p><u>Moderator</u></p> <p>Mr. Ken Waller, Director, The Australian APEC Study Centre</p> <p><u>Speakers</u></p> <p>Dr. Mark Lawrence, Lead Consultant Mr. Geof Mortlock, Consultant Mr. James Hennessy, Senior Vice President, Federal Reserve Bank of New York Ms. Laura Ard, Lead Financial Sector Specialist, The World Bank</p>
10:45 – 11:00	Morning Tea/Coffee break
11:00 – 12:30	<p>Session 3: Introduction to risk appetite</p> <p><u>Synopsis</u></p> <p>The session will define the term “risk appetite”, and discuss what it means</p>

	<p>for major banks and large financial institutions and how risk appetite relates to other risk management concepts, such as risk policies and limits. The session will also review relevant findings and recommendations from selected reports produced by industry and official sector organisations examining the role of risk appetite during the global financial crisis, including the Senior Supervisors Group and the Institute of International Finance.</p> <p><u>Moderator</u></p> <p>Mr. Ken Waller, Director, The Australian APEC Study Centre</p> <p><u>Presenter</u></p> <p>Dr. Mark Lawrence, Lead Consultant</p>
12.30 – 14.00	Lunch
14.00 – 15.30	<p>Session 4: Introduction to ‘risk culture’</p> <p><u>Synopsis</u></p> <p>The session will introduce and define the important concept of “risk culture” and examine the importance of risk culture as an essential ingredient of risk management effectiveness. The session will identify key risk culture attributes and typical weaknesses, and address the role of the bank boards and the CEO in diagnosing and shaping risk culture. The session will also include a first discussion of approaches to diagnosing risk culture strengths and weaknesses, including the use of staff questionnaires.</p> <p><u>Moderator</u></p> <p>Mr. Ken Waller, Director, The Australian APEC Study Centre</p> <p><u>Presenter</u></p> <p>Dr. Mark Lawrence, Lead Consultant</p>
15.30 – 15.45	Afternoon tea/coffee break
15.45 – 17.00	<p>Session 5: Risk appetite case study #1: Development Bank of Singapore</p> <p>Presentation of detailed case study regarding the implementation of risk appetite at DBS, followed by a Q&A discussion.</p> <p><u>Presenter</u></p> <p>Mr. Elbert Pattijn, Chief Risk Officer, DBS</p>

DAY TWO – Tuesday, 21 May 2013	
Theme: Risk appetite in detail	
8.45 – 9.00	Administration
9.00 – 10.00	<p>Session 1: Risk appetite case study #2: Commonwealth Bank of Australia</p> <p>Presentation of detailed case study regarding the implementation of risk appetite at CBA, followed by a Q&A discussion.</p> <p><u>Presenter</u></p> <p>Mr. Harrison Young, Chairman, CBA Board Risk Management Committee</p>
10.00 – 10.15	Morning tea/coffee break
10:15 – 11:15	<p>Session 2: Presentation of IIF’s Risk Appetite Working Group report findings</p> <p><u>Synopsis</u></p> <p>The session will present the key findings and recommendations of the IIF Working Group on Risk Appetite’s June 2011 final report on developing and implementing risk appetite frameworks. The session will also briefly review the key implications for supervisors which were noted in the IIF report.</p> <p><u>Moderator</u></p> <p>Mr. Ken Waller, Director, The Australian APEC Study Centre</p> <p><u>Speaker</u></p> <p>Dr. Mark Lawrence, Lead Consultant</p>
11.15 – 12.30	<p>Session 3: Panel discussion on IIF risk appetite recommendations and case studies</p> <p>The session will include a panel discussion on the IIF’s recommendations on risk appetite, as well as the presentations of the case study materials.</p> <p><u>Moderator</u></p> <p>Dr. Mark Lawrence, Lead Consultant</p> <p><u>Speaker</u></p> <p>Dr. Jin Cao, Deputy Head of Risk Management, ICBC</p> <p><u>Panellists</u></p> <p>Dr. Jin Cao, Deputy Head of Risk Management, ICBC Mr. Elbert Pattijn, Chief Risk Officer, DBS Mr. Harrison Young, Chairman, CBA Board Risk Management Committee Ms. Laura Ard, Lead Financial Sector Specialist, The World Bank Mr Geof Mortlock, Consultant</p>
12.30 – 14.00	Lunch

<p>14:00 – 15.30</p>	<p>Session 4: Facilitated workshop on developing and implementing an effective risk appetite framework in an emerging economy</p> <p><i>Synopsis</i></p> <p>The session will explore in detail the key challenges involved in developing and implementing an effective risk appetite framework in a large financial institution in an emerging economy, including:</p> <ol style="list-style-type: none"> 1. How to include and cover all risks (quantifiable & non-quantifiable); 2. How to link risk appetite to firm strategy; 3. How to effectively embed risk appetite in the front-line businesses, so as to guide day-to-day business decisions; 4. Whether and how to incorporate stress testing within the risk appetite framework; 5. Whether and how to incorporate culture and incentives within the risk appetite framework; 6. How to effectively and efficiently engage the board in the risk appetite process; 7. How to get started on risk appetite - what are the first steps, and the subsequent key steps in the process <p>Participants will form a number of working groups to consider and discuss how best to address these key challenges from the perspectives of different internal stakeholders, such as firm senior management, board directors, chief risk officers and others. Each group will prepare a short, structured report to be presented to the whole group for discussion among all participants.</p> <p><i>Facilitators</i></p> <p>Dr. Mark Lawrence, Lead Consultant Mr. Geof Mortlock, Consultant Ms. Laura Ard, Lead Financial Sector Specialist, The World Bank Mr. Ken Waller, Director, The Australian APEC Study Centre</p>
<p>15.30 – 15.45</p>	<p>Afternoon tea/coffee break</p>
<p>15.45 – 17.00</p>	<p>Session 5: Workshop continuation and conclusion</p> <p>Presentation and moderated discussion of group results, including first discussion of implications for supervisors.</p>

DAY THREE – Wednesday, 22 May 2013	
Theme: Supervisory objectives and challenges for risk appetite	
8.45 – 9.00	Administration
9.00 – 9.45	<p>Session 1: The link between risk culture and risk appetite</p> <p><i>Synopsis</i></p> <p>The session will discuss the role of risk culture in making risk appetite effective, and consider how risk culture can be included within risk appetite frameworks. It will also review and discuss the June 2011 IIF report’s specific recommendations in this regard.</p> <p><i>Moderator</i></p> <p>Mr. Ken Waller, Director, The Australian APEC Study Centre</p> <p><i>Presenter</i></p> <p>Dr. Mark Lawrence, Lead Consultant</p>
9.45 – 10.45	<p>Session 2: Facilitated workshop to identify the most important outcomes of the risk appetite process for emerging market banks</p> <p><i>Synopsis</i></p> <p>In this session participants will identify the most important <u>outcomes</u> of the risk appetite process, taking into account earlier presentations and discussions.</p> <p>Participants will form three working groups, with each group discussing and reaching its own conclusions regarding the most important outcomes of the risk appetite process for emerging market banks. Each group will present their conclusions to the whole group for discussion among all participants.</p> <p><i>Facilitators</i></p> <p>Dr. Mark Lawrence, Lead Consultant Mr. Geof Mortlock, Consultant Ms. Laura Ard, Lead Financial Sector Specialist, The World Bank Mr. Ken Waller, Director, The Australian APEC Study Centre</p>
10.45 – 11.00	Morning tea/coffee break
11.00 – 12.30	<p>Session 3: Facilitated workshop on key elements of the Risk Appetite Statement (RAS)</p> <p>In this session of the workshop participants will consider the following questions:</p> <ul style="list-style-type: none"> • Is it possible to identify some of the specific elements that would make up a good RAS for a large bank? • If so, what would these elements be, for an emerging market bank? • Is it <i>desirable</i> to try to specify the core elements of a "good" RAS - or should this question be deliberately left open and flexible, at this early

	<p>stage of consideration of RAS by regional agencies?</p> <ul style="list-style-type: none"> • Is it sufficient for supervisory agencies to know that the RAS is well-understood and thoroughly owned by the board and leadership team of the financial institutions they supervise or should these matters be subject to supervisory directives? <p>By considering examples from the case studies presented, the June 2011 IIF Risk Appetite report and elsewhere, participants will examine and discuss selected examples of elements from actual risk appetite statement (RAS) and seek to answer the questions above.</p> <p>The session will conclude with a whole group discussion.</p> <p><u>Facilitators</u></p> <p>Dr. Mark Lawrence, Lead Consultant Mr. Geof Mortlock, Consultant Ms. Laura Ard, Lead Financial Sector Specialist, The World Bank Mr. Ken Waller, Director, The Australian APEC Study Centre</p>
<p>12.30 – 14.00</p>	<p>Lunch</p>
<p>14:00 – 15.30</p>	<p>Session 4: Panel discussion on key supervisory objectives and challenges for risk appetite</p> <p><i>Synopsis</i></p> <p>This session will commence with a presentation from Geof Mortlock on supervisory issues relating to risk appetite statements, risk management, governance and culture. This will be followed by a presentation from CBRC which will describe and explain the approach to risk appetite that is being taken by supervisors in China, highlighting the role that supervisory guidance plays in the determination of risk appetite in large Chinese banks.</p> <p>Subsequently, the panel discussion will explore and discuss the following questions:</p> <ul style="list-style-type: none"> • What are the supervisory processes required to ensure that financial institutions develop and implement effective Risk Appetite Frameworks? • What guidance – if any - should supervisors provide to financial firms about how they should determine their risk appetite? What kinds of guidance can be helpful, and in what situations would it be beneficial for such guidance be provided? <ul style="list-style-type: none"> – In particular, should supervisors seek to specify or guide the <i>processes</i> which banks should follow to develop and implement their risk appetite? If so, under what circumstances should they do this, and what level of detail is appropriate? • How important is it for supervisors to look beyond the Risk Appetite Statement itself, to an examination of a firm’s underlying risk appetite processes? • How can supervisors effectively monitor whether firms are making adequate progress in risk appetite?

	<ul style="list-style-type: none"> • How can supervisors assess the effectiveness of firms’ risk appetite processes over time, which involves determining whether the risk appetite process and statement are having a measurable impact on firms’ business plans, day-to-day business decisions, risk outcomes and risk management effectiveness? • How can supervisors assess and understand the strengths and weaknesses of the risk culture within a firm, including the extent to which the risks are owned by the business units, and also the quality of the internal dialogue about risks and about the risk/return trade-offs within the firm? <p>The presentations and panel discussion will also include consideration of relevant concepts and recommendations from the 2010, 2011 & 2012 reports of the FSB’s Supervisory Intensity and Effectiveness Group (SIE) as appropriate, in particular the November 2012 FSB report <i>‘Increasing the Intensity and Effectiveness of SIFI Supervision.</i></p> <p><u>Moderator</u></p> <p>Mr. Ken Waller, Director, The Australian APEC Study Centre</p> <p><u>Panellists</u></p> <p>Mr. Geof Mortlock, Consultant (Presenter and panellist) Mr. Luo Ping, Director, CBRC (Presenter and panellist) Dr. Mark Lawrence, Lead Consultant Ms. Laura Ard, Lead Financial Sector Specialist, The World Bank</p>
15.30 – 15.45	Afternoon tea/coffee break
15.45 – 17.00	Session 5: Continuation of panel discussion

DAY FOUR – Thursday, 23 May 2013	
Theme: Risk appetite supervision – A way forward	
8.45 – 9.00	Administration
9.00 – 10.30	<p>Session 1: Corporate Governance and the FSB “Thematic Review Of Risk Governance”</p> <p><u>Synopsis</u></p> <p>The session will include a presentation and discussion of the key findings and recommendations from the February 2013 FSB “<i>Thematic Review of Risk Governance</i>”.</p> <p>The session will also consider how supervisors can effectively engage with boards and management of large financial institutions on risk appetite and culture issues, convey supervisory expectations and ensure appropriate board accountability.</p> <p>It will also highlight several key corporate governance issues related to the duties of directors and board risk committees arising from JPMorgan’s trading losses in 2012.</p> <p><u>Moderator</u></p> <p>Mr. Ken Waller, Director, The Australian APEC Study Centre</p> <p><u>Presenters</u></p> <p>Ms. Laura Ard, Lead Financial Sector Specialist, The World Bank Mr. James Hennessy, Senior Vice President, Federal Reserve Bank of New York</p>
10.30 – 10.45	Morning tea/coffee break
10.45 – 12.30	<p>Session 2: Facilitated workshop on supervision of risk appetite and risk culture</p> <p>The session will examine the way forward for supervision of risk appetite and risk culture. Participants will form 3 working groups, with each group to prepare a short presentation:</p> <ul style="list-style-type: none"> • <u>Group 1</u> will focus on the rationale for supervisors becoming involved in risk appetite and culture issues, and the linkage of risk appetite statements to the supervisory objectives of promoting sound financial institutions and financial systems. • <u>Group 2</u> will focus on the design of supervision policy on risk appetite and culture, including policy objectives, the span of risks to be covered by the RAS, whether the RAS applies only at a regulated entity level or consolidated group, the nature of guidance provided to regulated entities in developing RASs, and supervisory expectations for entities' boards, internal auditors and external auditors. • <u>Group 3</u> will focus on the implementation of the supervision process in

	<p>relation to risk appetite and risk culture, the approach that a supervisor might take in order to integrate risk appetite supervision into broader supervisory objectives, the extent to which a financial institution's risk appetite may influence supervisory intensity, and the nature of staff skills needed to perform the supervision of risk appetite and risk culture. This group will also consider how a supervisory authority can assess its effectiveness in supervising risk appetite and culture.</p> <p>Each group will make a short presentation (20 minutes) of their conclusions and recommendations to the whole group.</p> <p><u>Facilitators</u></p> <p>Mr. Geof Mortlock, Consultant Ms. Laura Ard, Lead Financial Sector Specialist, The World Bank Dr. Mark Lawrence, Lead Consultant Mr. Ken Waller, Director, The Australian APEC Study Centre</p>
12.30 – 14.00	Lunch
14:00 – 15.30	<p>Session 3: Facilitated workshop continued</p> <p>This session will consist of a moderated large group discussion, building upon the group presentations from the previous session.</p> <p>The objective of the discussion is for the whole group to draw summary conclusions and make recommendations, where possible and appropriate, about the following topics and key issues for the supervision of risk appetite (as well as any additional issues that may be identified by the group and arise as a result of the work done during the previous sessions of the program):</p> <ol style="list-style-type: none"> 1. Summarise the importance of risk appetite and risk culture within a large financial institution, and highlight the key relationship between these; 2. Identify and assess the key aspects of risk appetite that supervisors need to fully understand and make judgments on; 3. Identify the main elements of the supervisory approach to risk appetite and key supervisory tasks, ranging from requirements for large financial firms to define the Risk Appetite Framework (RAF) and to develop a Risk Appetite Statement (RAS), to supervisory assessment of these, to fully engaging bank boards to determine their awareness of risk appetite issues/concerns and ensuring board accountability for applying their risk appetite statement; 4. Explain how to integrate risk appetite into the on-going supervisory process, including risk based supervision, ICAAP, governance, internal and external audit, and interaction with bank boards; 5. Determine indicative timeframes for implementation in participating jurisdictions; and 6. Identify any supervisory capability or skill gaps which must be addressed. <p><u>Moderator</u></p>

	Mr. Ken Waller, Director, The Australian APEC Study Centre
15.30 – 15.45	Afternoon tea/coffee break
15.45 – 17.00	<p>Session 4: Program conclusion</p> <p>Facilitated discussion of key conclusions, potential next steps and future capacity-building initiatives.</p> <p><u>Moderators</u></p> <p>Mr. Ken Waller, Director, The Australian APEC Study Centre Dr. Li Kouqing, Director General, Asia-Pacific Finance and Development Center</p>