April 2024

Workshop 4
Risk management practices

Chair: Ho Hern Shin, Deputy Managing Director (Financial Supervision), Monetary Authority of Singapore

The banking turmoil that unfolded in March 2023 underscored the importance of sound risk culture, strong risk management practices, and sustainable business models for banks to successfully navigate an evolving risk environment. The *Core Principles for Effective Banking Supervision* (BCP) have similarly been revised in April 2024 to strengthen standards in these regards, amongst others. This note outlines the topics which will be covered in this workshop.

Risk culture

Risk culture embodies the collective norms, attitudes and behaviours related to risk awareness, risk-taking, and risk management and controls. It influences the decisions and actions of management and employees in their day-to-day activities, impacting the risks they assume on behalf of the organisation. Sound risk culture is characterised by a unified understanding of risks throughout the organisation, adherence to articulated risk appetites, as well as a proactive and robust approach to risk identification and mitigation.

In today's rapidly evolving financial landscape, a sound risk culture will enhance a bank's ability to adapt to new risks, including those posed by technological advancements, changing market conditions, and climate change. It fosters timely risk identification and appropriate assessment, escalation and treatment of emerging risks or risk-taking activities beyond the institution's risk appetite. Such timely and appropriate response to a changing business environment not only strengthens a bank's resilience and long-term sustainability but also presents opportunities for value creation.

Risk culture may be difficult to directly measure and observe as much of it is qualitative. Nonetheless, there are more tangible underlying factors that can be considered collectively to provide an indication of a bank's risk culture. These include the effectiveness of board, senior management and governance structures, the appropriateness of the accountability frameworks and the clarity of communication. The outcomes of sound or poor risk culture, such as frequent lapses in risk controls, are also often observable.

Q1. How has risk culture impacted supervisory outcomes in your jurisdiction?

Supervising and assessing risk culture

The supervision of risk culture brings together perspectives relating to governance structure, risk management practices and organisational culture. This goes beyond just adding more layers of controls to address lapses identified and seeks to draw tangible links between specific behaviours of bank staff and the bank's financial and/or customer outcomes so that deeper underlying issues can be addressed.

A practical challenge in the supervision and assessment of risk culture is that regulators are not in a position to prescribe a specific culture to all banks, since the primary responsibility for a bank's culture rests with the board and senior management. It is therefore important to strike the right balance between taking a more proactive supervisory approach towards culture and not unduly usurping decisions of a bank's board and senior management. How a sound risk culture is implemented will differ across banks given factors like their operating environment, business model, and staff profile, even if the desired outcomes are similar.

Another challenge lies in the perceived subjectivity in assessing culture and its effectiveness. Supervisors typically collect indicators or "red flags" to identify which aspects of a bank's risk culture require supervisory attention. However given their qualitative nature, such indicators may be more difficult to collect, and a wide range of evidence may be needed to identify tangible behavioural or interaction patterns and tendencies. Even with the data collected, it is often difficult to prescribe one-size-fits-all solutions, or to assess whether improvements made are sustainable.

Some authorities have recruited dedicated risk culture specialists, such as organisational psychologists and change management specialists, who have specific training in behavioural and culture assessment techniques such as observations and interviews. However, the supervision of culture remains relatively new in many jurisdictions. Insufficient resources to gather information and analyse risks negatively impacts the ability to detect cultural deficiencies before problems materialise.

Q2. What has been your experience in supervising risk culture in your jurisdiction?

Business model assessment

The banking turmoil in 2023 highlighted the importance of supervisors understanding the viability and sustainability of banks' business models as part of their supervisory process. This will allow them to identify, assess and take action to address any weaknesses at an early stage. Banks' ability to generate stable and sustainable returns is crucial for their safety and soundness.

Supervisors today have to assess the risks presented by complex and sometimes innovative business models and determine if and how to appropriately intervene and challenge banks with potentially non-viable or unsustainable business models. While the primary responsibility for designing and implementing sustainable business strategies lies with a bank's board, the impact of a bank failure argues for early intervention where possible.

Supervisors need to understand the strategies banks employ for revenue generation, risk management and operational efficiency to identify potential vulnerabilities that may compromise their long-term sustainability. A thorough assessment of banks' business models should involve a diverse range of quantitative indicators and qualitative information. This could consist of a bank's regulatory ratios, its risk-adjusted profitability and a broad set of risk indicators, including not only regulatory and market-based metrics but also confidential supervisory reporting, internal records and management information.

An effective system of banking supervision requires that supervisors develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance. This involves identifying, assessing and addressing risks emanating from banks and the broader banking system.

In instances where a bank is identified to potentially have a non-viable or unsustainable business model (which may be evidenced through excessively rapid growth, concentrated funding sources or exposures), supervisors should consider how to proactively engage with the bank. This engagement aims to further understand the associated risks and ensure the bank's capacity to manage them effectively. Such engagement should intensify in accordance with the significance of the issues or risks posed.

Q3. What has been your experience in assessing business model resiliency in your jurisdiction?

Supervisory judgment and effectiveness

Regulations ensure a foundational level of requirements, but rules alone may not adequately capture the complex risks posed by new business models and products. Relying solely on regulatory breaches to trigger supervisory interventions would undermine the timely mitigation of risks to financial stability.

The exercise of supervisory judgment allows for a more risk appropriate and proactive supervision strategy. Supervisors can tailor their oversight to the unique operational and risk profiles of individual banks, enabling early identification and mitigation of potential vulnerabilities. This is essential for adapting to the continuous evolution of the banking sector, characterised by digitalisation, changing customer demands and novel financial products and services.

The effectiveness of early intervention hinges on two supervisory capabilities. First, capabilities to identify and assess shifts in the risk landscape, including emerging risks such as use of Artificial Intelligence or shifts in geopolitical risks, or climate risks. Second, the ability and willingness of supervisors to make informed decisions amidst uncertain and incomplete information. This is a difficult task because early intervention also means greater uncertainty about the likely outcome of non-intervention. An ill-timed or incorrect intervention could end up crystallising a risk that may have otherwise been avoided.

The BCP emphasises the need to ensure supervisors have adequate resources and authority to enforce regulatory measures. This includes having the necessary legal powers, skilled personnel and technological capabilities to effectively oversee the banking sector. However, legislative and regulatory frameworks differ across jurisdictions. A takeaway from the banking turmoil in 2023 is that it is important for supervisory toolkits to be sufficient to drive concrete action at banks, and for supervisors to identify early any legislative/regulatory constraints on how or when they might be applied.

Some supervisory authorities may face constraints in pursuing and enforcing (pre-emptive) actions while a bank is still in compliance with regulatory requirements (eg where a bank is not in breach of regulatory ratios or other prudential requirements). Supervisors may be deemed to lack a legal basis for intervention and therefore be subject to legal challenge, even if they had identified risks that could threaten the bank's medium-term safety and soundness. In these cases, the authorities may have to rely on less robust tools to incentivise banks to address risks, which may prove less effective.

The Committee has previously published guidance on supervisory techniques and tools, including through the BCPs and the *Frameworks for early supervisory intervention* (2018). The latter sets out a ladder of increasing supervisory intervention from "normal/low risk" activities such as supervisory reviews through to "mandated actions/imminent risk" including the use of formal powers to require change or enforcement action.

Q4. How can supervisors be better equipped to understand and address emerging risks? Q5. How can supervisors strengthen their ability and willingness to meaningfully intervene early and not wait until a bank's condition deteriorates before acting?

Guidance for supervisors

As banks continue to evolve, it is increasingly important that supervisors have comprehensive tools and a clear understanding of how they can be used to ensure financial stability. The BCPs serve as a foundational reference, but additional guidance may be needed to address specific risk areas or emerging challenges, and to ensure supervisory practices remain effective and relevant in the face of changing industry dynamics.

Establishing and publishing supervisory reference guides may be critical for enhancing risk management and supervisory practices in a range of areas. By codifying these practices, supervisors can have a clearer understanding of the expectations and standards for managing specific risks.

Q6. In what areas would it be useful to have more detailed guidance for supervisors?