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SSM supervisory statement on governance and risk appetite

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BANKENTOEZICHT BANKTILLSYN BANKU UZRAUDZĪBA BANKŲ PRIEŽIŪRA NADZÓR BANKOWY VIGILANZA BANCARIA BANKFELÜGYELET BANKING SUPERVISION SUPERVISION BANCAIRE BANČNI NADZOR MAOIRSEACHT AR BHAINCÉIREACHT NADZOR BANAKA BANKING SUPERVISION PANGANDUSJÄRELEVALVE SUPERVISÃO BANCÁRIA BANKOVNÍ DOHLED BANKENAUFSICHT БАНКОВ НАДЗОР BANKTILSYN ΤΡΑΠΕΖΙΚΗ ΕΠΟΠΤΕΙΑ PANKKIVALVONTA SUPRAVEGHERE BANCARĂ BANKOVÝ DOHĽAD SUPERVIŻJONI BANKARJA SUPERVISIÓN BANCARIA BANKING SUPERVISION BANKENAUFSICHT SUPERVISÃO BANCÁRIA

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Executive summary

Internal governance is one of the top supervisory priorities of the Single Supervisory Mechanism (SSM) and one of the key elements of the Supervisory Review and Evaluation Process (SREP) on annual basis. Indeed, an institution's internal governance and risk management have a significant impact on its overall risk profile and business model sustainability. This is especially the case in an environment in which banks face economic, financial, competitive, and regulatory headwinds. Such an environment drives even more the focus on sound governance and risk management practices within a clearly articulated risk appetite framework (RAF).

An in-depth assessment of the institutions' management bodies and their RAFs was conducted in 2015 across all significant institutions (SIs)[1] in the euro area through a thematic review. This provided an opportunity to take stock of the governance frameworks of these institutions from a harmonised perspective across the SIs under the direct supervision of the ECB, in line with the SSM principles.[2]

Following the same supervisory approach, the SSM performed deep and granular assessments of banks' management bodies in charge of supervisory and management functions and banks' RAFs. A proportionate approach was developed to take into account the size, business model and complexity of the institutions. The main outcomes of this assessment are reflected in the SREP decisions and will be taken into account in future fit and proper assessments as appropriate.

This report conveys some lessons from the thematic review and describes some good practices observed across the SIs. It also sets out supervisory expectations[3] regarding a bank's board[4] and RAF, acknowledging all existing governance structures.

This report does not aim to give exhaustive guidance on effective governance and RAFs. Instead, it aims to support and guide institutions towards the implementation of international best practices. Although major improvements have already been made, most SIs are still far from international best practices.

The SSM has high and specific expectations regarding banks' boards. Boards should challenge, approve and oversee the management's implementation of the bank's strategic objectives, governance and corporate culture. In this respect, the SSM expects the board to demonstrate its capacity for independent challenging and oversight of senior management. This implies that an institution's board should have an adequate composition and effective organisation in order to ensure that it has the capacity to challenge senior management. The board should include a risk

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1 This concerned 113 SIs. From the total number of SIs, those in a wind-down process or with very specific business models were excluded.

2 See *Guide to banking supervision*, ECB, November 2014.

3 See *A New Paradigm: Financial Institution Boards and Supervisors*, Group of Thirty, October 2013.

4 "Board" refers here to the management body in its supervisory function, which means the management body acting in its role of overseeing and monitoring management decision-making, as defined in Article 3(8) of the Capital Requirements Directive (CRD IV).

perspective on strategic discussions and demonstrate effective oversight of risk and control functions. In particular, the board should be strongly involved in the validation process and monitoring of the RAF.

The SSM also expects banks to develop and establish a comprehensive RAF, which should help them to strengthen risk awareness and promote an adequate risk culture. As a prerequisite for sound risk management, the RAF should define the level of risk tolerance that the institution is willing to take in relation to both financial and non-financial risks. Risk metrics and limits should be deployed consistently within entities and business lines, and should be monitored and reported to the board regularly. The RAF should also remain aligned with the business plan, strategy development, capital and liquidity planning, and remuneration schemes of financial institutions.

The thematic review on risk governance and appetite is a starting point in our engagement with the boards. The SSM will continue to foster dialogue and interaction with management bodies in order to promote adequate and sound governance arrangements.

1 Introduction

The Single Supervisory Mechanism (SSM) is particularly focused on the soundness of the banking sector's business models and profitability in an environment in which banks face economic, financial, competitive, and regulatory headwinds. Low profitability and pressure on business models might push some banks towards a perilous search for yield, especially in the context of cheap and ample funding. Supervisors and banks therefore need to be vigilant that business models evolve in a manner that is sustainable over the long run. This drives the focus on sound governance and risk management practices within a clearly articulated RAF.

Furthermore, experience from the financial crisis has shown that banks' management bodies were not always able to implement and oversee the necessary governance arrangements aimed at ensuring the adequate risk information required to make sound business and risk management decisions. Governance is therefore one of the top supervisory priorities of the SSM.

According to the SSM standards, "internal governance" refers to the internal organisation of an institution and the way it conducts and manages its business and risks. As part of the overall corporate governance, internal governance includes the definition of the roles and responsibilities of the relevant people, functions, bodies and committees within an institution and how they interact. Therefore, internal governance is a key element within the Supervisory Review and Evaluation Process (SREP). As with other elements – business model, capital and liquidity – the assessment of internal governance is a key element in the SREP decision. Identified weaknesses can lead to supervisory actions being included in the subsequent supervisory examination programme required by Article 99 of the Capital Requirements Directive (CRD IV)[5].

Given the overall impact of internal governance, the ECB's Supervisory Board approved the launch of an extensive thematic review on risk governance and appetite at the SSM level as part of its 2015 supervisory priorities. This also provided an opportunity to take stock of the governance framework of significant institutions (SIs) with a harmonised perspective across the SSM.

In accordance with the SSM's principles,[6] this thematic review followed a harmonised risk-based approach for each SI with the aims of fostering consistency within the Single Market and identifying sound practices. A proportionate approach was also developed, taking into account the size, business model and complexity of the institution.

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5 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338)

6 See *Guide to banking Supervision*, ECB, November 2014.

The assessment of internal governance and risk management, as part of the SREP in 2015, has benefited from the main outcomes of the thematic review. In particular, in the case of breaches or weaknesses with a major impact on the institution's risk profile, the related requests for action have been included in the SREP decisions.

2 Overview on the thematic review

The thematic review was structured in two parts. The first part focused on the assessment of the organisation and composition of the boards, the quality of debate and the documentation supporting the decision-making process. The second part was aimed at assessing the RAF in terms of policies, design and governance as well as its deployment within entities and business lines.

With the aim of fostering consistently high standards, the assessment followed a two-layer approach: it assessed (i) compliance with national and European legislation and (ii) consistency with best international practices. In this respect, the SSM acknowledges the differences in national legal frameworks, without advocating any of the existing governance structures, as defined within each national framework.

Relevant supervisory tools used during the thematic review included meetings with key function holders, assessment of board documentation and minutes, and attendance as observers at one or two specific board meetings. Conclusions of relevant on-site inspections were also included in the assessment.

Bank-specific assessments were benchmarked using a horizontal approach in order to compare practices across peers, ensure consistency in the severity of the findings and guarantee that similar findings lead to similar recommendations. They are also linked with the SREP and where necessary are followed up as part of the “fit and proper” assessment process. The horizontal approach also allows the identification of sound practices in the operational implementation of international standards.

With the objective of enhancing engagement with the boards, the Joint Supervisory Teams (JSTs) discussed the bank-specific findings and benchmarks in October 2015 as part of a supervisory dialogue with the institutions, and also as a follow-up to the dialogue which had started earlier to share the outcomes of the SREP 2015.

The thematic review was finalised at the beginning of 2016 with the issuance of follow-up letters for all the institutions, listing concrete recommendations.

3 Supervisory expectations regarding the functioning and effectiveness of boards

3.1 Board composition

The composition of the board[7] is one of the key drivers of its effectiveness. In this respect, the thematic review assessed the overall composition of each board in order to determine whether the board's members were collectively in a position to adequately perform its functions. The objective was to assess the "collective suitability" of the board in the sense of collective knowledge, expertise and diversity and not to assess individual members.[8]

With regard to a board's composition, the main focus areas identified as having a potential impact on its functioning were (i) size and structure, (ii) insufficient independence, (iii) collective knowledge and diversity of board members, and (iv) succession planning.

Size and structure of the board

The size and structure of the board can have an impact on the quality of debate on the board and hence on its effectiveness.

The thematic review identified the following focus areas in this respect.

First, regarding the size of the board, a large board can hamper interactive discussions. Conversely, small boards sometimes face issues of diversity in the composition of their committees. Second, a lack of clarity in the definition of the scope, structure and composition of a board's committees can limit the comprehensiveness of the topics discussed on the board.

The size of a board should not adversely affect its functioning. However, a few institutions have been identified where the high number of board members is not conducive to interactive discussions. Institutions facing board size issues have been invited to internally assess[9] how the situation influences the board's performance and to identify measures to improve its performance.

7 "Board" refers here to the management body in its supervisory function, which means the management body acting in its role of overseeing and monitoring management decision-making, as defined in Article 3(8) CRD IV.

8 The ECB is currently in the process of drafting a guide on fit and proper supervision which will be published in 2016.

9 With the involvement of the nomination committee, in accordance with Article 88(2) CRD IV.

In relation to structure, it is expected that a board's committees will be designed to increase efficiency and allow deeper focus in specific areas. In this respect, the structure and scope of committees should be clear in order to avoid confusion resulting from possible overlaps on some topics. Particular attention was paid to the structure and functioning of risk and audit committees. In this respect, the ECB considers that all significant supervised groups should have separate risk and audit committees at the level of the parent undertaking, or at the highest level of consolidation within the participating Member States, as explained in more detail in the ECB Guide on options and discretions available in Union law.[10]

The SSM follows the approach defined by the Basel Committee on Banking Supervision (BCBS)[11] regarding the structure and composition of board committees: SIs should have distinct risk and audit committees with separate chairs, who are not the chair of the board or of any other committee. Furthermore, the compositions of the risk and audit committees should be different. However, in order to ensure appropriate information flow, some members may serve on both committees.

Independence

The thematic review identified that the level of independence on the board as a whole could be further strengthened in several institutions. Indeed, the assessment confirmed that having independent members on the board contributed to enhancing its capacity to independently challenge senior management. Conversely, insufficient independence on the board as a whole or in its committees (especially the audit and risk committees) limits its oversight capacity.

From a theoretical point of view, independence should be understood both as "formal" independence and independence "in mind".

Regarding "formal" independence, the board should include a sufficient number of independent directors in order to facilitate effective oversight of senior management. As stated in the BCBS's Corporate governance principles for banks, the need for a sufficient number of formally independent board members should also apply to the committees, especially the audit committee (all the members) and the risk committee (at least half of the members).

"Formal" independence should be based on national criteria defined in national legislation or by national competent authorities (NCAs), since there are no formal independence criteria in the CRD IV.[12] These national criteria might relate, for

10 See *ECB Guide on options and discretions available in Union law*, ECB, March 2016.

11 *Corporate governance principles for banks*, BCBS, July 2015.

12 The European Banking Authority (EBA) is currently revising its fit and proper guidelines and will provide further guidance regarding formal independence criteria. See *Guidelines on the assessment of the suitability of members of the management body and key function holders (EBA/GL/2012/06)*, EBA, November 2012.

instance, to previous executive positions held in the group, the number of years spent on the board, and possible family links with senior managers.

In order to promote checks and balances, the chair of the board should be an independent or non-executive board member.[13]

Particular attention was paid to cases where the chair was also identified as the chief executive officer (CEO). In line with the Article 88 CRD IV and the ECB's policy recommendations and stances on that provision, the combining of the two positions in one person may be authorised by the ECB on a restrictive basis and only if there are mitigating measures in place to ensure that the responsibilities and accountability obligations of both positions are not compromised by their combination.[14]

The SSM strongly promotes a consistent approach among institutions on this matter, monitoring in general whether the separation of the executive and non-executive functions is ensured.

Finally, regarding independence "in mind", board members should not have any potential conflicts of interest that may impede their ability to perform their duties independently and objectively without influence from other persons or other positions held. As part of ongoing supervision, the JSTs will continue to assess whether banks have an adequate conflicts of interest framework to properly manage potential conflicts of interest on an ongoing basis.

Collective knowledge and diversity

The composition of the board as a collective body is also a key feature when assessing its composition. In this respect, the board should possess adequate knowledge, expertise and diversity to be able to understand the institution's activities, including the main risks proportionate to the size, complexity and risk profile of the bank.

The collective knowledge of the board has often been assessed as an area for improvement. JSTs have identified some areas of expertise that could be further strengthened, such as IT and accounting. In this respect, induction arrangements and ongoing training are not always sufficient to ensure risk awareness and thus foster the necessary quality of debate. Finally, for larger and international institutions, the national diversity on the board has been assessed as insufficient in a few cases.

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[13] In jurisdictions where the chair is permitted to assume executive duties, the bank should have effective measures in place to mitigate any adverse impact on the bank's checks and balances. See paragraph 62 of *Corporate governance principles for banks*, BCBS, July 2015.

[14] See the draft Addendum to the ECB Guide on options and discretions available in Union law, recently published and submitted for public consultation until the 21 June 2016.

The SSM expects all board members to be in a position to understand the business model of the institution and the regulatory framework and to be able to challenge executive members. For this reason, where needed, institutions have been invited to identify any potential gaps in areas of knowledge and define corrective actions. In these cases, in accordance with Article 88(2) CRD IV, the nomination committee should have a crucial role in identifying issues concerning knowledge, skills and experience both of individual members of the management body and of the management body collectively, and report to the management body accordingly.

Depending on the materiality of such gaps, they could be overcome through relevant additional training or through the appointment of a new member with the missing expertise. If they impair the collective suitability of the board, such gaps can be taken into account in “fit and proper” assessments.

As good practice, some institutions appoint board members with a specific expertise or national backgrounds on the basis of the future business development. In addition, some institutions have developed in-depth training programmes, divided into a common part and a bespoke part, structured on the basis of an expertise-matrix, depending on the specific background of each individual member.

Succession planning

The thematic review identified some institutions in which succession planning was not defined or left room for improvement. This jeopardises the continuity of activity on the board, especially if some board members have key areas of expertise as part of the collective knowledge of the board and/or there is a concentration of departures of board members within a short period of time.

The SSM expects institutions to formalise a succession process, i.e. the way they ensure the adequate transition and continuity of activity of board members. This can be set out in an ad hoc document or included in the charter of the board. Where several members of the board leave at the same time, institutions are required to develop and implement mechanisms to avoid and mitigate those effects.

As good practice, in some institutions, the profile of possible future candidates is identified in advance. In a few cases, a list of potential candidates is drawn up as a precautionary measure intended to address situations in which it might be difficult for the institution to find potential successors.

3.2 The functioning and effectiveness of boards

3.2.1 Quality of debate and the board's capacity to independently challenge

As stated in the BCBS's Corporate governance principles for banks, the board of an institution is expected to challenge, approve and oversee the management's implementation of the bank's strategic objectives, governance framework and corporate culture. In this respect, the SSM expects the board to demonstrate a capacity for strong, independent challenging and oversight of the management body in its executive functions as well as compliance with the requirement that all members of the board should commit sufficient time to the performance of their functions.

The thematic review concluded that the quality of debate on the board, and hence its capacity to independently challenge the management body in its executive functions, could be further enhanced in a majority of institutions. The possible root causes vary from one institution to another, but often relate to the following: (i) the board's practices and organisation, (ii) quality of documentation, (iii) interactions among board members.

As required by Article 88 CRD IV, a board self-assessment should be regularly performed by the institution so that the board can reflect on its functioning, practices and dynamics. This self-assessment should also be discussed during board meetings.

The organisation of boards

A board's practices and organisation play a vital role in the quality of debate. On this topic, the thematic review identified that (i) the time of debate is sometimes too limited, owing to the low frequency or length of meetings, (ii) the documentation is not sent sufficiently far in advance to board members, (iii) board members are not sufficiently proactive in defining agendas, and (iv) there are some information asymmetries among board members.

First, time dedicated to debate should be sufficient, with agendas reflecting the size and complexity of the institution. It is therefore essential that the full board and its main committees meet frequently and for a sufficient length of time. In sound observed practice, the frequency of the meeting of the risk and audit committees ranges from 6 to 8 times per year for larger SIs and is quarterly for smaller SIs.[15]

Second, the SSM expects board members to prepare thoroughly for meetings and thus be in a position to identify areas in which they can challenge the management body in its executive functions. In some institutions, board documentation is systematically submitted at least five working days in advance so that board members have sufficient time to read and analyse it.

Third, board members are expected to play a proactive role in preparing the agendas of meetings, suggesting topics to be discussed rather than leaving it to senior management to set them. Furthermore, the board should regularly ensure that agendas cover a comprehensive range of topics, reflecting the size, complexity, business model and risks of the institution. For example, some institutions have implemented a process of agenda-setting across the year (albeit adjusted on a regular basis) to ensure comprehensive coverage of all risks and material processes.

Boards should also develop practices to facilitate interaction among the different committees and thereby reduce information asymmetries among board members. Regular reports by the chairs of board committees to the full board can facilitate information sharing among board members. In addition, it is recommended that all board members be granted access to information discussed in all board committees.

The SSM will also continue to assess the time commitment of board members in order to ensure they are in a position to dedicate sufficient time to their function, which is a prerequisite for active involvement in board meetings.

Interactions among board members

The quality of debate and the capacity to independently challenge also depend on the interactions among board members and, in particular, on the ability of the chair of the board to foster interaction among its members.

The thematic review identified that excessive concentration of power, domination of the debate by an individual or a group of members, and information asymmetries among board members reduce the quality of debate and thus impair the oversight role of the board in several institutions. The capacity of non-executive board members to challenge executive members has also been identified as a key area for attention in a majority of SIs.

In this regard, SIs are expected to define measures to allow open and critical debate on the board, ensuring that dissenting views can be expressed and discussed.

[15] These figures are indicative. The appropriate frequency of committee meetings depends on the individual institution.

Furthermore, in order to reduce information asymmetry among board members and to promote robust debate of issues, the SSM recommended that institutions put in place measures aimed at ensuring regular reporting by board committees to the full board (e.g. regular reports by the chairs of committees to the board, providing access to the information discussed in the committees).

As good observed practice, institutions were identified in which the chair of the board fosters discussion and encourages members to present different views. Similarly, some institutions were identified where board members formulate specific requests and action points or ask for adjustments in the proposals submitted by executive members.

Quality of documentation

Experience from the financial crisis has shown that banks' management boards did not always have at their disposal the relevant information required to make sound business and risk management decisions.

The main areas for improvement identified during the thematic review relate to (i) the lack of conciseness of the documentation, (ii) its lack of clarity, (iii) the impact of data aggregation issues on the quality of the risk reports, and (iv) insufficient detail in the minutes of board committee meetings.

Such shortcomings in the quality of a bank's internal documentation might reduce the quality of debate on the board and as a consequence its ability to have an appropriate understanding of the risks faced by the institution.

It is therefore essential to have clear and concise documentation, enabling meaningful discussions at board level. Even on technical topics, supporting documentation should be tailor-made to the board's needs, i.e. with executive summaries and highlighting the risks, opportunities, costs and benefits of the various items on which the board is expected to make decisions.

The board should also maintain appropriate records of its deliberations and decisions so that they provide an adequate summary of matters reviewed, recommendations made, decisions taken and dissenting opinions.

3.2.2 Oversight of the internal control framework

The thematic review identified that oversight by boards of control functions (risk, compliance, and internal audit) should be further strengthened. This concerns both the regular reporting by these functions to the board and the involvement of the board in the assessment of their effectiveness.

More generally, the thematic review concluded that risk perspective should be further enhanced in board discussions in most of the institutions.

As stated in the BCBS's Corporate governance principles for banks (paragraphs 110, 136 and 139) and in the European Banking Authority (EBA) Guidelines on Internal Governance (GL 44, 2011, paragraph 24), the board should have full and direct access to heads of internal control functions and this access should not be intermediated through executive management. Equally, the heads of the internal control functions should report regularly to the board or its relevant committees. Some SIs have implemented a semi-annual report from the chief compliance officer (CCO) to the risk committee concerning the main developments and risk areas related to compliance. In addition, many institutions were identified where the CRO reports quarterly to the risk committee. In the largest institutions, this frequency is even higher.

Risk and control functions should be adequately positioned. For example, each institution should have a chief risk officer (CRO) or a senior risk officer with exclusive responsibility for the risk management function and for monitoring the institution's risk management framework across the entire organisation. Although the CRO reporting line differs from one institution to another, the CRO should report to the board and/or the CEO and should have direct access to the board or its risk committee without impediment.[16]

Similarly, the CCO, as part of the second line of defence, is expected to have sufficient authority, stature, independence, resources and access to the board. The CCO should report directly to the board.[17] Similarly, the internal audit function, as part of the third line of defence, should be fully independent of business lines and of the second line of defence. In practice, the internal audit function should have a direct reporting line to the board or to the audit committee (or its equivalent). In addition, it should promptly inform senior management about its findings so that timely corrective action can be taken.[18]

Finally, regarding the inclusion of a risk perspective in decision-making, as sound observed practice, some institutions were identified where the consequences of strategic topics in terms of risks are discussed on the board. This concerns, for instance, discussions on strategy definition, budgetary process, external acquisitions, asset transfers, IT projects, etc. The minutes provide evidence of these discussions and of their impact on the decision-making process.

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[16] See the fourth sub-paragraph of Article 76(5) CDR IV.

[17] See *Corporate governance principles for banks*, BCBS, July 2015.

[18] See *The internal audit function in banks*, BCBS, June 2012, and *Corporate governance principles for banks*, BCBS, July 2015.

4 Supervisory expectations regarding the risk appetite framework

A well-developed risk appetite framework (RAF), articulated through the risk appetite statement, is a cornerstone of a sound governance framework, together with a strong risk culture and well-defined responsibilities for risk management and control functions.

4.1 Designing a risk appetite framework

The formalisation of the RAF is a prerequisite for its effective implementation.

The thematic review identified heterogeneity in the maturity of the RAFs of SIs. Having a formalised and integrated RAF is still something relatively recent for several SIs (mainly for smaller SIs). At the time of the thematic review, around 30% of the RAFs of the SIs had been developed within the last 18 months and 12% were still under development. The maturity of the RAF also has an impact on its effective implementation.

Even if its RAF is composed of a set of existing risk policies, an institution should formalise a summary statement to ensure consistency in its risk management procedural framework so that the board obtains a holistic view of the institution's risks. In addition, the RAF documentation should describe the responsibilities of all the stakeholders involved in accordance with the organisation of the bank. It should also formalise the interplay between the RAF and other strategic processes such as the budget, ICAAP, ILAAP, the recovery plan and the remuneration framework.

The management bodies of the institution, which are responsible for validating the RAF in the first place, should be regularly updated about the institution's risk profile relative to its risk appetite in order to be in a position to take appropriate decisions. Specifically, institutions should develop an aggregated and consolidated risk appetite dashboard, comparing the risk exposure and risk limits to the appetite for both financial and non-financial risks. This dashboard should be presented to the board regularly (at least quarterly for larger institutions) to support its review, oversight and monitoring of the risk profile of the institution.

Scope

The thematic review identified (i) that the scope of the RAFs of the SIs was not always comprehensive, with some material risk areas missing, such as non-financial risks or profitability and business risk, and (ii) that the risk appetite metrics were not always adjusted properly to the institution's business model and risk profile.

The scope of the risks included in the RAF should be comprehensive. In the most mature RAFs, the risks included emerge from a risk identification exercise carried out on a regular basis by the institution (usually on an annual basis). The risk areas covered by the RAF should reflect the material risks of the business model of the institution, in most of the cases at least: business risk and profitability, capital risk, liquidity risk, interest rate risk in the banking book (IRRBB), credit risk, market risk, operational risk, non-financial risks, etc.

Based on the results of the thematic review, material non-financial risks (in particular compliance risk, reputational risk, IT Risk, legal risk and conduct risk) are expected to be included more explicitly in the RAF, if not with quantitative proxies at least with qualitative statements.

Once the various risks have been identified, banks should define corresponding metrics. Institutions face many challenges when defining RAF metrics. First, metrics presented to the board should reflect the business model, size and complexity of the institution. In some more advanced RAFs, metrics present a common denominator to capture the downside risk for the institution as a whole, such as stressed losses, which can then be allocated to businesses, risks and legal entities. Second, there should be a proper balance between static metrics and forward-looking ones, including results of stress tests. Last, but not least, the number of metrics presented to the board should be appropriate, meaning there should be a sufficient number of metrics to cover all the risk dimensions, but this number should remain limited to ensure the clarity of the dashboard. In practise, JSTs found that an appropriate number of metrics presented to the board could range from 20 to 30, depending on the size and complexity of the institution.

Limits

The calibration and monitoring of limits has been identified as one area for improvement following the thematic review: (i) risk appetite limits are not set at an appropriate level to manage risk-taking effectively, (ii) limits do not include enough material concentration areas (per single name, sector and/or country), (iii) the escalation process in the event of a limit breach is not defined or displays weaknesses, (iv) data aggregation issues hamper an effective reporting of limit breaches.

Risk appetite limits should be set at an appropriate level to manage risk-taking effectively, meaning that they should be adapted to the risk profile of the group and be set such that they would be hit before any regulatory requirement is breached. In addition to the limits, the thematic review identified it as sound practice that a few institutions had implemented early warning thresholds for all risk appetite metrics and limits presented on the risk appetite dashboard to allow sufficient time to avoid breaching the risk appetite limits and had defined mitigating actions sufficiently in advance.

Risk appetite limits should establish the level and types of risk that the institution is willing to assume in advance of and in order to conduct its business activities within its risk capacity. In particular, one recommendation from the thematic review was that institutions should implement limits on all types of concentration (single-name, cumulation of top single names, sectors, countries) if they had not been defined.

The institution should also define and implement a process for regularly monitoring and reviewing its risk appetite limits, including an escalation process in the event of limit breaches, clarifying the roles of the various stakeholders. In this respect, it is essential that institutions have effective management information systems to be able to report any limit breach adequately and in a timely manner. This was identified as an area for improvement for SIs which will be closely monitored by the SSM in the thematic review on data aggregation performed in 2016 and through other ongoing supervisory tasks.

4.2 Implementation of the framework

RAF, strategy and risk culture

In accordance with the Financial Stability Board (FSB)'s principles for an effective RAF,[19] the SSM regards the establishment of an effective RAF as a strategic tool to reinforce a strong risk culture in financial institutions, which in turn is critical for sound risk management.

The thematic review concluded that, for most of the banks, the RAF needs to be integrated and embedded more closely into the other structural processes of the institution, such as strategy, budget process, capital and liquidity planning, recovery plan and remuneration framework.

[19] *Principles for An Effective Risk Appetite Framework*, FSB, November 2013.

The institution should ensure that the risk appetite statements are stable across time and are used as drivers of the strategy of the institution, rather than the strategy dictating the risk appetite. Risk appetite statements should outline all levels and types of risk that the bank is willing to assume within its risk capacity to achieve its strategic objectives and business plan. Therefore, the risk appetite statements should govern the annual limit setting, with due consideration for economic cycles and financial volatility, ensuring that at all times there is sufficient headroom to risk appetite thresholds if a limit is breached, consistent with the bank's overall risk appetite. This will facilitate corrective steps to remain within the overall risk appetite. In view of this, the framework should allow flexibility in order to respond to environmental changes. However, the risk appetite statements must also be definitive and consistent enough to avoid strategic drift.[20]

In practice, the thematic review identified situations in which the RAF is a substantial part of the decision-making process of the institution: it is used as a basis for the discussions on the budget between senior management, the various business units, the departments responsible for risk management, and the subsidiaries of the institution. Risk appetite boundaries are decided before the commercial target parts of the budget are decided.

Furthermore, RAFs should be used to guide behaviour towards risk awareness. In particular, variable remuneration should be linked and conditioned to some risk factors, both ex ante (key risk-related performance indicators used as an input to calculate variable remuneration) and ex post ("malus" provisions in the event of non-compliance with key risk indicators). Recommendations emerging from the thematic review address in particular the need to strengthen the link between risk and remuneration in line with Article 94 CRD IV, improving the implementation of risk indicators in the calculation of remuneration, the transparency of the remuneration system and its ability to be understood by the employees.

Finally, the institution should have in place a process of communication with its employees in order to explain to them how their job affects the risk appetite of the bank. As a concrete illustration, some institutions have developed training programmes on risk appetite, including exams and certification, through which the management is able to monitor the employees' understanding of RAF and the organization's risk culture.

Governance and deployment

The thematic review identified that the quality of the governance and deployment of the RAF depends on its level of maturity. In some more recent, less mature RAFs, the governance often needs to be better formalised. However, even in more mature RAFs, the involvement of key stakeholders such as the board and the internal audit

20 *Observations on Developments in Risk Appetite Frameworks and IT Infrastructure*, Senior Supervisors Group, December 2010

function should be further strengthened. Last, but not least, for all the institutions, the establishment of the RAF at the level of entities and business lines could still be improved.

The RAF needs to be supported by a strong governance framework, with clear roles for all the stakeholders involved at all levels of the institution (board, senior management, risk function, business lines, legal entities, etc.).

As part of the overall corporate governance framework, the SSM expects boards to take a more active role both in the definition of the RAF and in its monitoring. Risk appetite statements are also expected to be used to promote robust discussions on risk and strategic issues not only on the board but also together with risk management and internal audit functions.

In addition, an independent review of the RAF should be performed regularly by the internal audit function to assess its effectiveness. Institutions which perform such reviews generally do this on an annual basis, including an assessment of the overall framework and of the adequacy of the limit breaches identification, escalation and reporting.

The RAF should also be deployed within the institutions. This means that risk appetite statements should be established for business lines and entities in order to ensure that their strategy and risk limits, as relevant, align with the institution-wide risk appetite statement, as appropriate.

Furthermore, in order to facilitate risk monitoring at sub-consolidated levels, institutions are also expected to develop risk appetite dashboards for material business lines and entities, derived from the approach developed at group level.

5 Conclusions and next steps

The thematic review identified that most SIs still need to improve their governance and risk appetite frameworks to be in line with international best practices.

Ensuring sound governance is the institutions' responsibility. In this respect, institutions have already started defining actions to address the areas of concerns.

The thematic review confirmed that effective governance is feasible in any corporate structure across the different SSM jurisdictions. The effectiveness of the board and the quality of the RAF do not depend on the size and complexity of an institution, but on the robustness and soundness of the governance arrangements in place.

The performance of the thematic review has allowed the SSM to identify follow-up supervisory actions for 2016, as well as areas for forthcoming on-site inspections and aspects to focus on as part of the SREP process. As part of their ongoing supervision, JSTs will follow up on the implementation of the actions included in the individual follow-up letters sent to banks.

Deep-dive investigations will be performed on a sample of SIs on specific governance areas, such as the oversight role of the board on risk and control functions and the RAF implementation. The yearly SREP will assess the implementation of all the measures and action plans that institutions have communicated in order to remedy all the relevant findings.

The SSM will continue fostering the dialogue with the boards through regular meetings and using a string of different tools to assess governance, including on-site inspections, documentation analysis, meetings, ongoing "fit and proper" tests, etc. In addition, SSM supervisors may attend parts of board meetings as observers from time to time to see how the board functions and to convey some specific messages.

Governance will remain at the top of the SSM priorities in order to continue to foster the highest standards in all institutions and consistency among them. While this report reflects the lessons from the thematic review conducted across the SIs, which are directly supervised by the ECB, many of the lessons are also valid for the less significant institutions, which are directly supervised by the NCAs. A consistent approach is ensured across the whole of the SSM in close coordination with the NCAs and in accordance with the principle of proportionality. In the follow-up of the thematic review, the SSM will also continue to build on its policy recommendations and stances and work on the promotion of good practices. The SSM will also continue to play an active role at EU and international levels in the definition of international standards.

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