

# Global Regulatory Network

## Executive Briefing

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## An international regulatory push for enhanced risk governance

The recently released, revised *Corporate Governance Principles for Banks*<sup>1</sup> (*Principles*), from the Basel Committee on Banking Supervision (BCBS), highlights the shift in regulatory expectations for enhanced risk governance globally. In the words of the BCBS, “the revised guidance emphasizes the critical importance of effective corporate governance for the safe and sound functioning of banks.” The *Principles* build on recent work by the Financial Stability Board (FSB)<sup>2</sup> and various regulatory and international agencies following the financial crisis.<sup>3</sup>

The *Principles* stress “the importance of risk governance as part of a bank's overall corporate governance framework and promote the value of strong boards and board committees together with effective control functions.”<sup>4</sup> An important objective was “to emphasize key components of risk governance such as risk culture, risk appetite and their relationship to a bank's risk capacity.”<sup>5</sup> The guidance calls on national supervisors to strengthen their ability to assess the effectiveness of a bank's risk governance and risk culture.

Key changes from the BCBS's October 2010 *Principles* include:

- ▶ Higher expectations for boards collectively and directors individually, notably a broader oversight role and a more systematic approach to director selection
- ▶ A much stronger focus on the need for fully functioning three lines of defense, particularly frontline and individual accountability, second-line risk aggregation and high-quality third-line assurance
- ▶ An elevated focus on conduct risks and risk culture
- ▶ More detailed expectations of boards and management with regard to key, new regulatory requirements, such as subsidiary governance, stress testing and outsourcing

In light of emerging regulatory guidance (such as the *Principles*), as well as investor demands for more effective controls, EY's *Risk Governance 2020*, which include a series of white papers, focuses on helping banks navigate their risk governance journey over the coming years.<sup>6</sup>



## Higher expectations for boards collectively, and directors individually

The *Principles* reflect the broadening of non-executive-director roles that has taken place in the years following the financial crisis.<sup>7</sup> Notably, more focus is placed on the board's role in:

- ▶ Risk oversight, including the need to establish and oversee adherence to the bank's risk appetite statements (RAS), risk policy and risk limits
- ▶ Approving and overseeing the implementation of the bank's capital-adequacy assessment process and capital and liquidity plans
- ▶ Selecting and evaluating the performance of the CEO, key members of senior management and the heads of the control functions
- ▶ Overseeing conduct risks, risk culture and compliance

Board composition is addressed in more detail, with greater emphasis on qualifications and skills required by board members, as well as the need for an effective approach to selecting, recruiting and training new directors.

Reflecting a broader global regulatory focus on board effectiveness, there are higher expectations for board, committee and director performance evaluations. In this context, the *Principles* offer guidance to supervisors on evaluating the effectiveness of bank governance in their ongoing supervisory process, and recommend supervisors routinely meet with non-executive directors and senior executives. Such interactions were relatively scarce pre-crisis.

The *Principles* highlight the central role of board committees, with expanded guidance on the roles, responsibilities and composition of core committees, particularly audit and risk. The revised *Principles* highlight several additional audit committee roles, including framing policy on internal audit and financial reporting and reviewing third-party opinions on the effectiveness of the overall governance framework. The *Principles* also note that risk committee oversight should include discussion of all risk strategies on an aggregated basis and by risk type, and the implementation of processes to promote adherence to the bank's risk appetite and risk policies.

Principle 4 clearly articulates senior management's role in enabling timely and accurate reporting to the board so it can carry out its role effectively. This includes changes in business strategy and risk appetite, the bank's performance and financial condition, breaches of risk limits or compliance rules, internal control failures and legal or regulatory concerns.

### Implications for banks:

- ▶ Boards should review their governance structures, such as committee mandates and working protocols, committee structures, overlaps and coordination, and the approach to board and committee evaluations. Board and committee composition should be reviewed in light of current needs and expectations to have the requisite skills and competences. This will allow firms to ensure they are in line with global best practice, and directors are effectively discharging their expanded and demanding oversight duties.



## A much stronger focus on the need for fully functioning three lines of defense

Reflecting a global regulatory shift, the *Principles* put significant emphasis on the need for a fully effective three-lines-of-defense model.<sup>8</sup> Risk management, compliance and internal audit were addressed in the 2010 *Principles*, but the revised *Principles* stress the fact that these functions are part of a broader, integrated risk and control model: "... each of the three lines has an important role to play."<sup>9</sup> Expanded guidance is offered on each function, as well as the front line.

The *Principles* call for:

- ▶ **Frontline and senior management accountability.** Notwithstanding the need for enhanced second- and third-line effectiveness, the *Principles* clearly put the onus on frontline management of risk, financial and nonfinancial: "The business line – the first line of defense – has 'ownership' of risk, whereby it acknowledges and manages the risk that it incurs in conducting its activities."<sup>10</sup> This underscores a broader global regulatory emphasis on frontline and individual accountability, as seen in past FSB reports and specific guidance, such as the Prudential Regulatory Authority's Senior Management Regime<sup>11</sup> and the Office of the Controller of the Currency's Heightened Standards.<sup>12</sup> The *Principles* also highlight the role of senior management accountability in this context: "[S]enior management should implement business strategies, risk management systems, risk culture, processes and controls for managing the risks – both financial and non-financial – to which the bank is exposed and concerning which it is responsible for complying with laws, regulations and internal policies."<sup>13</sup>
- ▶ **Strengthened risk management.** The *Principles* expand guidance on the risk function, including a greater emphasis on the need for robust risk appetite frameworks, in line with 2013 FSB guidance.<sup>14</sup> Adherence to the risk appetite should be monitored on an ongoing basis, with early warning triggers in place to avoid breaching related limits. The effectiveness of the risk appetite framework should be evaluated periodically. The *Principles* note that banks' RAS should "include qualitative statements to address reputation and conduct risks as well as money laundering and unethical practice."<sup>15</sup> The board's essential role in overseeing risk management is highlighted to a greater degree, with specific guidance on the board's or risk committee's role in selecting, evaluating, compensating and firing the chief risk officer (CRO).
- ▶ **Enhanced compliance.** The guidance dedicates Principle 9 to compliance, viewing it as a "key component of the bank's second line of defense."<sup>16</sup> Prior guidance referred to internal controls, but little on compliance specifically. The revised *Principles* highlight a significant role for compliance, including advising the board and senior management, and employees at large, on compliance matters, training, and in "supporting corporate values, policies and processes that ensure that the bank acts responsibly and fulfils all applicable obligations."<sup>17</sup> The compliance function requires sufficient authority, statute, independence and resources to succeed. Nonetheless, the board and management remain accountable for compliance.
- ▶ **Stronger internal audit.** The central role of internal audit is elevated. Principle 10 requires internal audit to conduct periodic assessments of the effectiveness of the risk management and compliance functions; the quality of risk reporting to the board and senior management; and the effectiveness of the bank's system of internal controls. As with the CRO role, the *Principles* highlight the critical role of the board or audit committee in selecting, evaluating and firing the head of internal audit.
- ▶ **Effective risk-data systems.** In line with *Principles for effective risk data aggregation and risk reporting*,<sup>18</sup> the new *Principles* emphasize the need for the risk management infrastructure – including data infrastructure, data architecture and information technology infrastructure – to be adapted over time to "keep pace with developments such as balance sheet and revenue growth; increasing complexity of the bank's business, risk



configuration or operating structure; geographical expansion; mergers and acquisitions; or the introduction of new products or business lines.”<sup>19</sup>

#### **Implications for banks:**

- ▶ Banks should review their three-lines-of-defense structure to ensure it enables strong front line accountability for risk, effective oversight of aggregate risk in the second line, and high quality assurance in the third line. A core focus should be on the management of nonfinancial risks, such as IT, legal and conduct risks, where the lines of defense may not be as clearly articulated as they are for financial risks.
- ▶ With active board oversight, banks should review the talent and resources assigned to the three lines, particularly risk, compliance and audit. A central focus should be the depth of executive-level succession planning in these areas.
- ▶ Banks should re-evaluate their risk management information systems to ensure they are appropriate for current, emerging risk-data needs.

## **An elevated focus on conduct risks and risk culture**

International and domestic regulators have placed much more focus on culture and conduct risks over the past few years, in light of continued control failures and significant fines and settlements. The *Principles* emphasize this shift, with culture referenced more than 10 times more often than in the 2010 *Principles*.<sup>20</sup> The revised version incorporates 2014 FSB guidance on risk culture.<sup>21</sup>

The *Principles* highlight the need to:

- ▶ **Define conduct risk.** The *Principles* expect “board members and senior management ... to define conduct risk based on the context of the bank’s business.”<sup>22</sup> Such risks include consumer protection, wholesale and corporate matters (e.g., conflicts of interest) and market conduct.<sup>23</sup>
- ▶ **Reinforce corporate culture.**<sup>24</sup> The *Principles* highlight the critical role of boards in reinforcing corporate culture, tone at the top, ethical behavior and risk awareness across the organization. Senior management has a central role, too, in establishing and modeling the right behaviors, in implementing robust risk-and-control frameworks, and in promoting accountability and transparency throughout the bank.
- ▶ **Define, monitor and report on risk culture.** Boards are viewed as responsible for establishing the firm’s corporate culture and values, for ensuring processes and policies are in place to enforce the culture, and for ensuring that the values are communicated effectively. The *Principles* state that the risk committee is responsible for reporting on the state of risk culture within the bank.
- ▶ **Enable effective escalation.** Greater emphasis is placed on the need for bank corporate values to promote “timely and frank discussion and escalation of problems to higher levels within the organization.”<sup>25</sup> This includes encouraging and enabling employees to escalate concerns without reprisal. Such escalation should be set within a culture that promotes risk awareness and encourages open communication and challenge about risk-taking.
- ▶ **Link compensation and risk.** The *Principles* further underscore the need for effective processes to link compensation with risk-taking and require boards to “oversee the bank’s approach to compensation, including monitoring and reviewing executive compensation and assessing whether it is aligned with the bank’s risk culture and risk appetite.”<sup>26</sup>



### Implications for banks:

- ▶ Firms should review their approach to identifying, measuring, monitoring and mitigating conduct risk and their approach to systematically evaluating and reinforcing risk culture. The board and risk committee role in conduct and culture should be reviewed to ensure directors are appropriately engaged on the important matters.
- ▶ Approaches to evaluating incentives from a risk perspective should be expanded beyond financial compensation to nonfinancial incentives and performance management systems, as well as recruitment, training, promotion and disciplinary processes. Board compensation and risk committees should rigorously re-evaluate compensation and relevant human resource processes from a risk perspective.

## More detailed expectations of boards and management with regard to key new regulatory requirements

The role of the board has expanded materially post-crisis as new regulatory requirements stress the need for board or committee review and effective challenge.

The *Principles* highlight three critical areas:

- ▶ **Effective organizational governance from parent to subsidiary to legal entity.** In a post-crisis world of recovery and resolution planning, the *Principles* place greater emphasis on requirements for effective governance processes at the group, subsidiary and legal-entity level. At the group level, the *Principles* require group boards to establish a group structure that delineates clear roles and responsibilities, includes processes to identify and manage material risks at each level and intragroup conflicts of interest, and includes appropriate subsidiary board and management structures. Subsidiary level governance structures should include robust and independent risk management and control processes and connect appropriately with group governance structures. The *Principles* highlight the balancing act firms have to manage: sufficiently distinct and independent subsidiary governance, but with significant alignment with the group strategy, risk governance framework and corporate values. Overall, the governance structures should “maintain an effective relationship with both the home regulator and, through the subsidiary board or direct contact, with the regulators of all subsidiaries.”<sup>27</sup>
- ▶ **More robust use and integration of stress testing.** The guidance expands on the role of stress testing within banks. Stress tests and scenario analysis are actively promoted as important, ongoing management tools, not just periodic capital adequacy exercises for regulators. In line with the feedback large banks have been receiving from their regulators over the past few years as they have conducted periodic regulatory stress tests, the *Principles* underscore that stress tests should not be viewed in isolation: “Test results should be incorporated into the reviews of the risk appetite, the capital adequacy assessment process, the capital and liquidity planning processes, and budgets. They should also be linked to recovery and resolution planning.”<sup>28</sup> Hence, more integrated stress testing processes are required. The role of the board in providing an effective challenge to the scenarios and models, and to periodically review stress test results, is highlighted.
- ▶ **Effective analysis and oversight of outsourcing risks.** The *Principles* require risk management to have a material role in determining the risks associated with outsourcing and in analyzing the outsourcer’s ability to manage risks and comply with legal and regulatory obligations. The guidance requires banks to critically assess their risk management, legal and regulatory compliance, information technology, business line and internal control functions to ensure they have adequate tools and expertise to measure and manage outsourcing risks. Globally, prudential regulators have more rigorously assessed banks’ outsourcing arrangements, especially in those areas viewed as critical to the firms’ critical operations or that may inhibit orderly resolution.



### Implications for banks:

- ▶ Banks need to review their group, subsidiary and legal entity structures, with a view to enabling the appropriate level of group and local level board and management oversight, risk management, control structures and information flows, and to ensure severability or resolvability in times of severe stress.
- ▶ Banks should review their approach to stress testing to ensure it is sustainable (and less cumbersome to execute each year), integrated with other key management processes, such as risk identification frameworks, used for risk management as well as regulatory purposes, and has appropriate board level oversight and challenge.
- ▶ Banks should review their outsourcing arrangements, particularly as they relate to their capabilities to assess, monitor and manage outsourcing risks.

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## The time to act is now

The call for action by regulators for more robust risk governance requires a prompt response by boards and senior management. Prompt action not only meets regulators' – and, increasingly, shareholders' – demands for improved corporate governance, but also makes good business sense. Ultimately, significant rewards can be reaped when firms are better managed and controlled, such as capturing market opportunities faster, properly pricing risks and avoiding unnecessary risks.

The regulatory focus is set to grow. As the FSB noted in its May report on global supervisory practices for systemically important banks, "it will be critical that supervisors ensure that institutions' approaches to risk governance, risk appetite, and risk culture promote sound risk management that acts as an adequate defense against excessive risk taking. Supervisors must be prepared, and empowered, to act when this is not the case."<sup>29</sup>

Therefore, it is essential that work start today. The *Principles* highlight that meeting broader and more demanding expectations will be a journey for each firm. While the task ahead is formidable, firms will rise to meet this challenge if they are to promote growth, long-term profitability and their overall competitiveness.

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### Learn more

- ▶ [Risk Governance 2020](#) offers a broad set of perspectives on how large financial institutions can successfully transform their governance approach to meet higher regulatory and investor expectations and to govern and manage firms more successfully.

## EY Global Regulatory Network Executive Team Previous appointments

**Mario Delgado:** FROB (Spanish Banking Resolution Authority) Head of International Coordination and EBA and FSB representative; Spanish Ministry of Economy; Director of Office of the Secretary of State for the Economy in the Economic Affairs; Head of the Spanish Delegation in the Paris Club; Deputy Head of relations with the IMF.

**Marie-Hélène Fortés:** Autorité de Contrôle Prudentiel (French Prudential Supervisory Authority); Association Française des Banques (French Banking Association); and French National Institute for Statistics and Economic Studies. She has also held senior roles at a global investment bank

**Dr. Tom Huertas:** UK Financial Services Authority's Executive Committee; Alternate Chair of the European Banking Authority, Basel Committee on Banking Supervision; and Financial Stability Board Resolution Steering Committee

**Patricia Jackson:** Basel Committee Member; Basel II lead; Global Quantitative Impact Studies Committee Chair; Basel II Calibration Subgroup chair; Head of the Financial Industry and Regulation Division of the Bank of England

**Hidekatsu Koishihara:** Chief inspector and inspection administrator for the Japan Financial Services Agency, Ministry of Finance (MOF) of Japan; Japan's former financial regulator as financial inspector at the Bank Bureau of MOF and Financial Inspection Division; and Minister's Secretariat of MOF

**Dr. Colin Lawrence:** Director of Risk Specialists at the UK Financial Services Authority; Senior Manager and Transition Committee Member at Prudential Regulatory Authority; and Senior Risk Strategist to the Deputy Governor at Bank of England

**John Liver:** Divisional Compliance Lead at Barclays; Head of Department, Investment Firm Supervision, and prior roles in enforcement and supervision of investment management, life insurance and pensions at the UK Financial Services Authority and its predecessors. Current EY/UK Financial Conduct Authority relationship lead

**Keith Pogson:** Immediate Past President of the Hong Kong Institute of Certified Practising Accountants; more than 20 years of experience advising governments and regulators across Asia-Pacific on acquisitions, market entry strategy and due diligence across banking, asset management and securities

**Ted Price:** Deputy Superintendent and Head of Supervision at the Office of the Superintendent of Financial Institutions, Canada, serving on the Senior Supervisors' Group and the Financial Stability Board Supervisory Intensity and Effectiveness Working Group. Prior to OSFI, Ted held senior roles at a global investment bank

**Philip Rodd** has more than 23 years of experience in accounting and risk management, including 13 years in the Asia-Pacific region. His areas of expertise include assisting clients in assessing the impact of regulatory change, implementing compliance initiatives, and responding to regulatory findings

**Marc Saidenberg:** Senior Vice President and Director of Supervisory Policy at Federal Reserve Bank of New York; Basel Committee Member and Liquidity Working Group Co-chair; involved in the development of supervisory expectations for capital planning, liquidity risk management and resolution planning

**David Scott** is involved in addressing emerging regulatory and legislative initiatives and engaging in dialogue with regulators and supervisors on emerging issues. He has worked with a number of large global institutions, most recently on the implementation of the global financial regulatory reform agenda

**Rick Small:** Deputy Assistant Director, Federal Reserve System, Enforcement and Investigations, and Policy Leader for anti-money laundering and sanctions; executive leadership positions overseeing global financial crimes risk and compliance functions at American Express, Citigroup and GE Money; former federal prosecutor

**Donald Vangel:** Federal Reserve Bank of New York, 1980-1997, ultimately as Senior Vice President, Bank Supervision. Don has been with EY for 18 years, and is currently Regulatory Affairs Advisor, US Financial Services Office

**Judy Vas:** Currently sits on the Hong Kong Takeovers Panel, Takeovers Appeals Committee and the Hong Kong Securities & Investment Institute Examination Committee. Former managing director, Head of Regulatory Affairs and Head of Compliance for Asia (excluding Japan), Goldman Sachs

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### About the EY Global Regulatory Network

EY's Global Regulatory Network helps our clients find solutions to their regulatory challenges, providing extensive experience, leadership and strategic insights on financial regulation. Led by Dr. Tom Huertas, former Alternate Chair of the European Banking Authority, the network comprises more than 100 former regulators throughout the Americas, Asia and Europe, many with senior regulatory experience, including membership in the Basel Committee, the Financial Stability Board, the European Banking Authority, the Federal Reserve Bank of New York and the Japanese Financial Services Agency. The network enables our clients to understand and adapt to the impact of the changing regulatory landscape, advising on such topics as:

- ▶ Capital and liquidity
- ▶ Recovery and resolution
- ▶ Governance
- ▶ Risk culture and controls
- ▶ Structure
- ▶ Conduct

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- <sup>1</sup> *Revised principles on corporate governance for banks issued by the Basel Committee*, press release, July 8, 2015.
  - <sup>2</sup> See, for example, *Thematic Review on Risk Governance: Peer Review Report*, Financial Stability Board, February 2013.
  - <sup>3</sup> For example, the Council of the Organisation for Economic Co-Operation and Development recently approved revisions to its *OECD Principles for Corporate Governance*.
  - <sup>4</sup> *Op.cit. Revised principles on corporate governance for banks issued by the Basel Committee*.
  - <sup>5</sup> *Corporate Governance Principles for Banks*, Basel Committee on Banking Supervision, July 2015, p 3.
  - <sup>6</sup> For more information, see *Risk Governance 2020 – From satisfactory to effective and sustainable*, EY, May 2015, or visit [www.ey.com/rg2020](http://www.ey.com/rg2020).
  - <sup>7</sup> For more perspective on addressing heightened expectations of boards, see *Bank boards are set to undergo further transformation*, EY, July 2015.
  - <sup>8</sup> For more insight on evaluating the three lines of defense, refer to *Risk Accountability – Responsibility must be shared*, EY, July 2015.
  - <sup>9</sup> *Op.cit. Principles for Corporate Governance in Banks*, p 5.
  - <sup>10</sup> *Ibid.*
  - <sup>11</sup> “Strengthening individual accountability in banking and insurance – responses to CP14/14 and CP26/14,” Prudential Regulatory Authority, March 2014.
  - <sup>12</sup> “OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches; Integration of Regulations (Final Rule),” Office for the Comptroller of the Currency, September 2014.
  - <sup>13</sup> *Op.cit. Principles for Corporate Governance in Bank*, p 20.
  - <sup>14</sup> “Principles for an Effective Risk Appetite Framework,” Financial Stability Board, 2014. For more information, see *Risk appetite and risk responsibilities*, EY, July 2015.
  - <sup>15</sup> *Op.cit. Principles for Corporate Governance in Banks*, p 2.
  - <sup>16</sup> *Op.cit. Principles for Corporate Governance in Banks*, p 31.
  - <sup>17</sup> *Ibid.*
  - <sup>18</sup> *Principles for effective risk data aggregation and risk reporting*, Basel Committee on Banking Supervision, January 2013.
  - <sup>19</sup> *Op.cit. Principles for Corporate Governance in Banks*, p 27.
  - <sup>20</sup> The 2010 *Principles* mention “culture” three times. Excluding definitional and footnote references, the revised *Principles* mention it 33 times.
  - <sup>21</sup> “Guidance on Supervisory Interaction with Financial Institutions on Risk Culture,” Financial Stability Board, 2014.
  - <sup>22</sup> *Op.cit. Principles for Corporate Governance in Banks*, p 5.
  - <sup>23</sup> For a more expanded definition, see “What is conduct risk?” in *Risk culture – much ado about something*, EY, June 2015, p 3.
  - <sup>24</sup> For more on addressing risk culture systematically, see *Risk culture – much ado about something*, EY, June 2015.
  - <sup>25</sup> *Op.cit. Principles for Corporate Governance in Banks*, p 10.
  - <sup>26</sup> *Op.cit. Principles for Corporate Governance in Banks*, p 9.
  - <sup>27</sup> *Op.cit. Principles for Corporate Governance in Banks*, p 22.
  - <sup>28</sup> *Op.cit. Principles for Corporate Governance in Banks*, p 28.
  - <sup>29</sup> *Thematic Review on Supervisory Frameworks and Approaches for SIBs: Peer Review Report*, Financial Stability Board, May 2015, p 7.