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Targeted Reviews on Control Frameworks and Risk Appetite Statements in MiFID[1] Investment Firms & Market Operators ("Investment Firms" or "Firms")

Dear CEO

The financial landscape is undergoing a number of significant changes, with new business models and products, globalisation and digitalisation among some of those changes shaping the operational and risk landscape. As a result, it is imperative that Investment Firms have robust, future-proofed frameworks to support their customers to navigate this rapidly changing financial services landscape, particularly as traditional business models change and new more complex products are being offered to customers. As outlined in both the Consumer Protection Outlook Report and the Securities Markets Risk Outlook Report, Investment Firms must navigate this change in a manner that places proactive risk identification and sound risk management at the heart of their commercial decision-making to ensure that they are acting in the best interests of consumers and in line with their risk appetite. It is in this context that the Central Bank has engaged with Investment Firms on the importance of managing risks and this work has included a series of targeted reviews of Control Frameworks and Risk Appetite Statements ("RAS") across a sample of MiFID Investment Firms. In terms of both the design and implementation of the RAS, the Central Bank identified differing stages of maturity across the sample of Investment Firms reviewed.

The Central Bank acknowledges that risk is inherent in all business models, and that Investment Firms will have an appetite to take certain risks in the execution of their strategy. However, it is important to highlight that the Central Bank expects that all Investment Firms have appropriate capabilities and governance in place to enable the identification and management of all relevant risks.

[1] Markets in Financial Instruments Directive

The purpose of this letter is to outline the best practices and key findings identified during these targeted reviews. The Central Bank expects Investment Firms to fully consider the best practices as well as the key findings identified and evaluate their own risk and compliance governance structures, Risk Management Frameworks and their RAS to identify if any improvements are required. The good practices observed are set out in **Appendix 1** and key findings, together with associated Central Bank expectations, are outlined in **Appendix 2**.

The key findings set out in this letter are not exhaustive and Investment Firms should continually evaluate the effectiveness of their own Control Frameworks and associated governance.

Overview

Assessing the quality and implementation of the Control Frameworks, RAS and the risk and compliance culture within Investment Firms is a key part of the Central Bank's ongoing supervisory strategy. The MiFID Regulations[2] impose a number of requirements on regulated Investment Firms, including requirements to establish, implement and maintain adequate policies and procedures, internal control mechanisms and effective reporting. Investment Firms are required to monitor the on-going effectiveness of these policies and processes and to employ personnel with the necessary skills, knowledge and expertise to perform these roles. These requirements have been further supplemented with guidance including the Final Report on guidelines on internal governance under Directive (EU) 2019/2034 (EBA/GL/2021/14).

Recent targeted review work assessed how Investment Firms governed, resourced and embedded their Risk and Compliance Control Functions and evaluated the adequacy of the Risk Management and Control Frameworks in place. The RAS reviews assessed how Investment Firms identified, measured, monitored and reported material risks to their Risk Committees and Boards, and how Investment Firms cascaded risk appetite to all staff throughout their organisations. These reviews also considered how the RAS is used as an effective risk management tool in everyday practice.

The Central Bank, in seeking insights into the prevailing risk and compliance culture within Investment Firms, observed that effective risk management is grounded in a culture where risk and compliance are central to the success of the business. While good practices were observed, as highlighted in Appendix 1, the Central Bank identified notable deficiencies across the follow areas:

- Risk Management Frameworks and Governance

[2] Articles 21, 22, 23 and 24 of Commission Delegated Regulation (EU) 2017/565

- Board Oversight of Risk and Compliance Matters
- Application of Risk Appetite Statement as a Risk Management Tool
- Poor Risk Appetite Statement Design
- Risk Appetite Reporting to the Risk Committee and Board
- Cascading of Risk Appetite through the Organisation

The Central Bank's expectations are clearly set out in Appendix 2, in relation to these shortcomings.

Next Steps and Actions Required

The Central Bank expects all Investment Firms to consider the contents of this letter and review their Risk and Compliance Control Frameworks, including the RAS, against the good practices and findings detailed in the Appendices. Where gaps/weaknesses are identified, Investment Firms should develop and implement actions to address these in a proactive and timely manner. The Central Bank requires this letter to be discussed at the next Board meeting, and for the discussion to be recorded in the meeting minutes.

Please note that the issues raised in this letter may form part of future risk assessments, including inspections, carried out by the Central Bank. In addition, supervisors will discuss with individual Investment Firms matters raised in this letter during future supervisory engagement meetings.

Appendix 1 – Areas of Good Practice

1. Risk and Compliance Control Functions and Risk Management Frameworks

A number of Investment Firms have recently assessed and made enhancements to, the adequacy of both the level of resources and appropriateness of the experience and skillsets in their Risk and Compliance Control Functions. Some Investment Firms have made changes to enable these Control Functions to have a more appropriate balance between their risk advisory and assurance mandate, which supports the Control Functions discharging their important role of providing independent and credible challenge to Senior Management on risk and compliance matters. This included establishing a Risk Framework based on internationally recognised risk management standards. This approach supports the goal of having a mature, comprehensive and joined-up Risk Management Framework in place.

2. Holistic Risk Appetite Statement Dashboard

Some Investment Firms designed a holistic RAS Dashboard that succinctly and clearly outlined the material risks, the key risk limits and the Firm's current level of risk against the defined risk appetite. Certain Investment Firms embedded a risk taxonomy into their risk management processes to aid in the categorisation of material risks. Material risks were divided into sub-risks with clearly defined KRIs, which, helped inform both qualitative and quantitative risk appetite metrics. In addition, the use of a RAG status to indicate if risks were approaching risk appetite limits or had breached the defined limits helped inform decision-making. This clarity was reflected in reporting to the Risk Committee and Board, as seen by the adoption of a RAS Dashboard and evidenced in Board and Risk Committee minutes. This helped the Board and Risk Committee monitor the level of risk the Investment Firm was taking relative to its defined risk appetite for each material risk.

3. Risk Appetite Statement Linked to Strategic Objectives

There was strong risk identification of strategic risk reflected in the RAS amongst certain Investment Firms. This risk identification was consistent and aligned with the Investment Firms' strategic objectives. The use of appropriately calibrated qualitative and quantitative metrics enabled Firms to monitor and report the status of strategic risk against a defined risk appetite.

4. Individual Responsibility and Ownership of the Risk Appetite Statement

In some Investment Firms, the roles and responsibilities relating to the RAS were clearly documented and included individual ownership and accountability across each line of defence, the Risk Committee and Board. These Firms were able to provide documented evidence and clearly demonstrate how these responsibilities in respect of the RAS were discharged on a day-to-day basis - including how the risks identified were then measured, monitored, controlled and reported to the CRO, Risk Committee and to the Board as appropriate, with reference to the Firm's desired risk appetite.

5. Unacceptable Risks Formally Documented

Another good practice noted was that specific unacceptable risks were formally documented and combined with preventive controls. As an example, Investment Firms in conjunction with their Board, had considered, documented and formally approved geographic locations and/or industry sectors where there was no appetite to make investments. This decision was supported by key controls preventing employees from making an investment that was outside of the agreed risk appetite.

Appendix 2 - Key Findings

1. Deficiencies in Risk Management Frameworks and Governance

Some Risk Management Frameworks were not sufficiently comprehensive or joined-up to allow Investment Firms to effectively identify, monitor, manage and mitigate their risks, including new and emerging risks. Weaknesses were noted in the adequacy of resourcing of the Risk and Compliance Control Functions and, in some Investment Firms, the governance structures did not sufficiently enable the independence of these Control Functions. This raises concerns that the second line of defence may not be sufficiently supported to enable the robust operation of the Control Functions.

- ***Central Bank Expectations***

The Central Bank expects Investment Firms to maintain comprehensive, joined-up, embedded and sufficiently mature Control Functions and Control Frameworks. Investment Firms should have a holistic, structured, proactive and forward-looking approach to risk identification and mitigation, which is underpinned by a robust and embedded Risk Management Framework. Investment Firms should have Control Functions that are sufficiently resourced, with appropriate levels of experience and seniority that enable the Functions to implement and maintain an effective approach to managing risk and compliance matters including providing independent and credible challenge to Senior Management. Investment Firms are reminded of their obligation to comply with the MiFID Regulations[3] which, inter-alia, require them to establish, implement and maintain adequate policies and procedures, internal controls mechanisms and effective reporting. Investment Firms are also required to monitor the on-going effectiveness of these policies and processes and to employ personnel with the necessary skills, knowledge and expertise to perform these roles.

2. Board Oversight of Risk and Compliance Matters

The Central Bank observed practices and behaviours in a number of Investment Firms where Boards failed to sufficiently prioritise or engage with matters relating to risk and compliance and / or failed to recognise the Board's collective responsibility and accountability for these matters. For

[3] Articles 21, 22, 23 and 24 of Commission Delegated Regulation (EU) 2017/565

example, important risk and/or compliance matters being dealt with predominately at the Board Sub-Committee level with limited or no consideration by the full Board.

Cultural indicators observed are suggestive of a reactive approach being taken by Investment Firms with respect to risk and compliance matters. For example, the Central Bank observed limited self-initiated improvements made in Control Functions across the Investment Firm sector, with significant enhancements to frameworks primarily made following identification of concerns by the Central Bank and on foot of related Risk Mitigation Programmes. The Central Bank is of the view that this is indicative of a lack of embeddedness of an appropriate risk and compliance culture within Investment Firms.

- ***Central Bank Expectations***

The Board and its Sub-Committees are expected to operate effectively and in line with corporate governance best practices, and legislative requirements. The collective skillset of the Board should have sufficient experience, including a clear understanding of good market practice in risk and compliance matters, to provide effective oversight of, direction and challenge in these areas. The Board and Senior Management are expected to drive an appropriate risk and compliance culture in the Firm on an ongoing basis.

3. Application of Risk Appetite Statement as a Risk Management Tool

During the course of the targeted reviews, it was not evident that the RAS was utilised as an effective risk management tool to monitor, control and report material risks on a holistic basis and influence strong decision-making. Some boards did not recognise the importance of developing a robust RAS to help monitor and control the risks associated with their business activities. In some Investment Firms, there was a reliance placed on a Group RAS that did not adequately reflect the material risks pertaining to local entities.

- ***Central Bank Expectations***

There is an intrinsic link between the strategy and risk appetite of Investment Firms. The Board and Senior Management are expected to have developed robust and functional RAS, Risk Register and policies which reflect the local entity specificities rather than just an overall Group entity. The RAS should be tied into the Investment Firm's strategic objectives and used in the decision-making of the Firm. The RAS must be reviewed and approved by the Board on an annual basis. A mature risk culture will distinguish between an Investment Firm's risk tolerance and overall risk capacity and have measures for both.

4. Poor Risk Appetite Statement Design

The targeted reviews identified poorly designed RAS amongst certain Investment Firms. The RAS did not clearly articulate Firms' appetite and motivation for taking on or avoiding certain risks types. The identification of material risks was not clear, consistent or aligned across the relevant risk appetite documentation (e.g. the RAS, RMF, Internal Capital Adequacy Assessment Process (ICAAP) and Risk Registers). The desired level of risk the Investment Firm is willing to take for each material risk, both financial and non-financial was not evident, due to the limited use of quantitative metrics. In a number of cases, the design of the RAS did not reflect a holistic view of material risks and was not clearly linked to strategic objectives. In some instances, the documentation of risk appetite was disjointed and dispersed across several risk documents. In addition, there was little consideration evident of emerging risks in Investment Firms' RAS.

- ***Central Bank Expectations***

Investment Firms should ensure that qualitative descriptions of risk appetite correctly reflect the risks they are willing to take and are aligned to the overall business strategy. The RAS should reflect the holistic view of all material risks facing the Firm. The desired level of risk that an Investment Firm is willing to take for each risk type should be clearly outlined using quantitative KRIs, qualitative and quantitative risk tolerances and risk limits. The RAS should be forward looking, reflecting emerging risks facing the Firm. The RAS should be a dynamic document that reflects changes in the internal and external environment.

5. Deficiencies in Risk Appetite Reporting to the Risk Committee and Board

In certain Investment Firms risk appetite reporting to the Risk Committee and / or Board was not clear / concise and therefore could not properly inform decision-making. There was a lack of documented analysis to support the setting of risk limits or Early Warning Indicators (EWI) for material risk types. Investment Firms have not developed sufficiently robust quantitative key risk indictors (KRIs) to monitor, control and report on material risks, both financial and non-financial. Some Investment Firms were unable to detect risk appetite breaches due to poorly defined qualitative risk appetite descriptions and a lack of quantitative RAS metrics for both financial and non-financial risks. There was also an absence of a defined escalation process for RAS breaches as well as a lack of evidence of how Risk Committees and Boards obtained comfort that their Firm was operating within the approved risk appetite, as the risk appetite reporting was not presented in an informative manner. A number of Investment Firms did not have documented qualitative descriptions of risk appetite for specific risk types that reflected the actual level of risk taken on a day-to-day basis. As an example, some Investment Firms noted that there was no appetite for client asset risk despite holding client assets.

- ***Central Bank Expectations***

An Investment Firm should determine the risk capacity and risk profile that it is prepared to operate within, based on its risk appetite for each material risk and its overall risk appetite. The RAS should contain quantitative measures that are translated into risk limits applicable to business lines. In addition, the escalation process should be clearly defined and documented and the Investment Firm should establish thresholds for reporting on risk events to Senior Management, Risk Committees and to the Board. Risk appetite reporting should be presented in a clear manner reflecting the holistic view of material risks.

6. Deficiencies in Cascading Risk Appetite through the Organisation

In some Investment Firms, it was not evident if the Firm's overall risk appetite, risk appetite for material risks and applicable risk limits had been communicated throughout the Firm. It was not apparent that the first line business divisions were aware of the Firm's risk appetite, or their role in adhering to the Firm's risk appetite. The risk appetite and motivation for accepting risks, or the rationale for not accepting certain risks, was not formally documented in many cases. There was also a lack of formal risk appetite training provided to employees at all levels throughout the Firm.

- ***Central Bank Expectations***

Investment Firms should employ various methods of communicating risk appetite information throughout the Firm. At an operational level, risk limits should act to constrain or guide the activities of the business units to which they apply. In addition, business units should be aware of the existence of risk limits and the consequences of breaching such limits. Investment Firms should ensure that periodic risk appetite training is provided to all employees within the Firm.