Between the lines: why banks are rethinking risk management

Lloyds is not the only bank wanting to reshuffle the three lines of defence as tech risks grow

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01 Aug 2024

NEED TO KNOW

- Earlier this year, there were media reports of the UK's Lloyds Bank cutting jobs in risk management as part of a strategic review.
- Other banks have already begun rethinking the distribution of responsibilities across the three lines of defence, or even establishing a 1.5 line to strengthen risk management at the business unit level.
- The advantages of this are allowing business units to take ownership of more everyday risks, while leaving the second line freer to focus on more complex and less common risk types.
- However, it is unclear if regulators favour such structural changes, and some bankers think it is unnecessary to significantly downsize the second line.

In April this year, an internal memorandum at Lloyds Bank made its way into the media, announcing a cull of 150 jobs from its risk management function, amid complaints the division had acted as a "blocker". The reaction was noticeably divided.

Some decried the danger of subordinating risk management to the wishes of business lines – one of the mistakes that left Credit Suisse nursing the **heaviest losses** from the collapse of Archegos Capital Management. However, under the **original news report**, there were also plenty of comments purporting to come from former Lloyds clients, suggesting the risk division had indeed inhibited the functioning of the bank.
Risk.net has spoken to around 20 banks since the Lloyds story broke, and what becomes clear is that the UK firm is not an outlier. In fact, at least four other large banks have undertaken or begun a rethink of the relationship between the three lines of defence. Lloyds declined to comment for this article.

"For many years, the second line tried to build their own empire … this attitude that the more people you have, the more important you are," says one former chief risk officer (CRO) at a large European bank, who also has experience as a front-office executive. That approach needs to stop, they add: "You need to know what the three lines of defence are, and what their purpose is."

Moreover, the reappraisal isn't necessarily driven solely by business units fretting about risk managers impeding growth. The emergence of new risks and the shifting balance of risks that banks face are also important factors. The Lloyds memo mentioned a greater focus on non-financial risks. That aligns with the rising regulatory burden around operational risk, including the European Union's **Digital Operational Resilience Act** and recent US **third-party** risk management guidelines. It is also a stance that strikes a chord with risk managers at other institutions.

"The real challenge I will face in the next few years is not financial risk," says a CRO at a second European bank. "It's IT risk, and it's the role that Dora assigned to risk managers on third-party risk management."

For some banks, this means shifting some of the risk management capacity from second to first line – or even establishing a substantial risk management function within the first line, which some have dubbed the '1.5 line'.

"Both firms and their advisers need to be open-minded about alternatives to the three-lines-of-defence orthodoxy," says Will German, a consultant and former CRO at a UK challenger bank. "What is critical to making it work in practice is clarity about who does what and proper accountability for ensuring that it gets done."

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However, new concepts around the relationship between first and second lines still run up against the overarching regulatory emphasis on an independent risk function.

"The challenge is that regulators view the 1.5 model as not independent enough," says a CRO at a global bank.

Nervous new world

Whatever the distribution of power and resources between the first and second lines, there is a consensus that the skill set for risk management is changing. There are new challenges and staffing needs stemming from climate risk, cyber security and the adoption of models based on artificial intelligence that are very different from the traditional financial risks – especially credit risk, which dominates most banks' portfolios.

"You are having to build out the second line, requiring different skills than before," says a head of financial risk at a second European bank. Anand Thirunellai Radhakrishnan, senior director and industry practice lead for Moody's, adds that business models and market structure are

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also changing, especially in areas such as payments and digital assets.

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"There is a feeling that there is an inability for the second line of defence in assimilating the risks that come with the new business models," he says.

Since banks need to upskill their risk management teams in any case, this could present an opportunity to rethink the structure and ensure the second line can manage the processes for adapting to change. Building a stronger first line that is ready to take ownership of some of the more bread-and-butter credit, liquidity and operational risks could be one way to address this. Sources hold up Credit Suisse as an example of how a deficient first line can cause the whole model to fail because the second line becomes the only defence instead.

"I do believe in many cases that sometimes the second line is too skilled and therefore your concept of your ownership of risk is pushed to the second line," says the former CRO at the first European bank. "You saw that with Archegos and Credit Suisse."

The unusual suspects

The alternative model is a leaner second line that would leave the first line – or an explicit 1.5 line – to address more of the business-as-usual risks. The aim is also to avoid duplication of effort, or the second line compensating for first-line weaknesses by overloading business units with compliance guidelines and policies.

"With budgets under constant scrutiny, it is imperative that firms maximise the value of their investment in risk management, ensuring that resources are deployed in the most effective manner," says German.

A former CRO at a large asset manager also believes it makes sense to assign the first line with risk management responsibilities that fit their core expertise. For example, the front office would be better qualified to value derivatives positions than a second-line compliance team.

"[Compliance] can't value a derivative book, but when things get unhinged in the financial markets, the financial side is the bigger risk," says the former asset management CRO.

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Sources say several global banks have already begun adjusting the balance between first and second lines. The key is to define a clearer role for the first line in governance structures, rather than simply adding further controls to its work.

"The decision-making is now in the first line, and your challenge is in the second line, so you need people [in the second line] who have experience across portfolios and are not doing the individual risk approvals," says the head of financial risk at the second EU bank. But they add: "I don't think we are there yet as an industry."

A head of operational risk and former CRO at a third European bank says the reorganisation of resources can also free up time for the second line to focus on less routine risks that need to be prepared for but are not part of normal business.

"There has been bird flu, swine flu … [But] if you look back, pandemics fell off the top 10 risks just a few years before Covid," says the op risk head. "Interest in geopolitics is [also] something that can give us insight into emerging risks – a lot of organisations have employed teams to look at these threats."

Middle way

There is little evidence, however, that regulators are enthusiastic about the 1.5-line concept or any major realignment of risk functions. In a June 2023 report, the Financial Markets Standards Board industry initiative warned of possible drawbacks that might make regulators wary of banks relocating more of the risk function into the first line: "Changes to ensure role segregation and independence within a line may lead to confusion of responsibilities."
As recently as May this year, the European Central Bank reiterated the importance of the three-lines-of-defence model in a supervisory newsletter. And in October 2023, the US Federal Deposit Insurance Corporation proposed extending the requirement for banks to establish clear separation between the three lines. Previously, this had applied only to the large national and global banks regulated by the Federal Reserve and the Office of the Comptroller of the Currency.
The FDIC proposal, partly in response to the failings exposed at Silicon Valley Bank last year, would push the obligation onto any federally guaranteed bank with assets of more than $10 billion.

In practice, not everyone thinks it is necessary to be as explicit as carving out a specific 1.5 line, and plenty of risk managers believe there is scope to find the right balance within the traditional three-line structure. The CRO of a second global bank that is currently reorganising its risk management suggests there's a middle way that could modernise roles and responsibilities without antagonising regulators.

"We need strong first-line risk managers to do risk frameworks, [but] we don't need a 1.5 line," says the CRO. "I don't subscribe to a model that would slim down the second line [because] it needs to be at the discussion table – that's when it's most effective."

The operational risk head at the third European bank agrees that "conversations" between the first and second lines are just as important as the exact allocation of responsibilities.

"[The] second line needs to be good at communication – it can't be an old-fashioned compliance person who looks at spreadsheets all day," says the op risk head.

Editing by Philip Alexander
