Risk management overhauls juggle speed and independence

Some banks say the 1.5 line of defence responds faster to risk, but supervisors are still divided

By Paulina Pielichata
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NEED TO KNOW

- Growing numbers of banks have adopted a so-called 1.5 line of defence, with risk managers sitting alongside the first-line business units.
- Possible attractions of this model include more investment into the risk function, and the ability to respond more pre-emptively to emerging risks, rather than waiting until they materialise.

- However, regulators want to ensure the continued independence of the risk function, and the post-SVB overhaul of US supervision means the 1.5-line approach is coming under fresh scrutiny.

Like a good doctor, a good risk manager knows that prevention is better than cure. When banking crises blow up, risk management teams in the second line of defence have to cope with the fallout, but they may also lament poor decisions taken by the business lines, sometimes months or even years earlier.

"The structure can be built on the last crisis based on who owns the loss – who cleans up the mess and remediates," says a chief risk officer (CRO) at a global bank.

That's the motivation behind enthusiasm for the idea of expanding the risk function within the business units, often dubbed the 1.5 line of defence. Sources cite the **severe volatility** at the start of Covid-19 lockdowns in March 2020 or the losses from the collapse of leveraged family office **Archegos** a year later, as moments that prompted a **reappraisal** of how expertise and responsibility are distributed among the three lines of defence.

"The investment going into the 1.5 expertise [is motivated by] the challenge around accountability and fixing problems as quicky as possible," says the CRO. That means retaining "close to the first line" at least some of the experts best qualified to manage the risks that are keeping executives awake at night.

"Where there is a heightened risk – **cyber** and **fraud** are probably the two key areas – that's seen investment in first line oversight or 1.5 line," adds the CRO, whose bank has adopted the 1.5-line model.

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Senior risk manager at a large US bank

Risk.net has spoken with four banks in total – three global, and one large US bank – all of which either use the 1.5 line of defence or are in the process of rolling out enhancements to the first line. But the experience of the US bank is also cautionary. It adopted the 1.5 line some time ago, but the distribution of risk management responsibilities in general is now caught up in the increased supervisory scrutiny since the downfall of Silicon Valley Bank in March 2023.

"We are right now going through a bit of [a] revamp of the model," says a senior risk manager at the large US bank. "As we prepare for the future, the regulatory expectations are heightened and are more intense for top banks."

Cyber imperative

The 2008 financial crisis led to not only vast credit and market losses related to subprime securities, but also a torrent of regulatory fines and investor litigation around the associated risk management failures. Banks responded with a total overhaul of risk functions, but sources say this primarily focused on substantially strengthening the second line of defence.

A decade-and-a-half later, a different kind of threat has led to a different response. The growing number of cyber attacks, and the speed with which they can disrupt a bank's operations, are prompting a discussion about moving information security expertise closer to the business units, so that they can respond faster to evolving risks.

The European CRO of a second global bank says chief information security officers (CISOs) in the US tend to sit firmly in the second line. By contrast, their own European subsidiary has recently hired a CISO with a small team that is essentially in the 1.5 line.

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European CRO of a global bank

“Should the information security risk officer be in the first line of defence or second line, or should they sit in the middle, and who they should report to?” says the European CRO. “We are taking a hybrid approach, where the officer sits in the first line, but reports to the CRO.”

Two banks say they have adopted similar configurations for different risks, including credit and counterparty risks, in an effort to ensure risk managers are close to the source of emerging threats.

A third global bank, which is headquartered in Asia, has already adopted the 1.5-line approach at the parent company level. A senior risk manager at the bank says it’s not just a question of which risks should be owned by the 1.5 line – banks may adopt this structure for some business units but not others.

“For personal banking, we have a very big department and a clear 1.5 line, but for other departments, it is not the same story,” says the senior risk manager at the third global bank, who adds that they would be open to extending the model to other divisions.

Regulatory scrutiny

The global bank headquartered in Asia is now planning to roll out the 1.5 line in its European operations. However, this is complicated by the fact that European supervisors have a different stance from the bank’s home jurisdiction. The senior risk manager says the European approach is not excessively prescriptive, but there is a strong focus on ensuring that responsibilities are clearly assigned.

This can be particularly difficult where there are emerging risks such as cyber, which could be tackled from multiple points within the organisation. The risk manager says existing regulations are not specific about where such teams should be housed, which leaves more room for unpredictable supervisory interpretation.
The senior risk manager at the large US bank agrees that uncertainty over supervisory attitudes is a challenge for adopting the 1.5 line. For

example, firms are informally receiving questions about role clarity and are required to ensure there is no overlap or a disconnect between the three lines of defence.

"You are hearing that regulators want banks to address their feedback in certain ways," says the risk manager at the US bank. "Regulators have a lot of avenues at their disposal, through which they can deliver formal as well as informal messages to banks."

The US Office of the Comptroller of the Currency added a specific expectation of three lines of defence in the **2019 update** to its supervisory handbook. In the UK, while the Prudential Regulation Authority (PRA) tries to take a principles-based approach to supervision, the Senior Managers and Certification Regime has an explicit expectation of an independent second line. And in a September 2023 **letter** to bank chief executives, the UK's Financial Conduct Authority explicitly warned against "a blurring of responsibilities between the first and second lines", especially in new areas such as environmental, social and governance risk.

For the CRO at the first global bank, part of the attraction of the 1.5 line is that it is sufficiently close to the profit centre to ensure the team receives adequate investment to stay ahead of emerging risks. Otherwise, improvements in risk management tend to be reactive, driven by failures, such as Archegos or JP Morgan's **'London whale'** losses, or by pressure from individual regulators.

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>
> **CRO at a global bank**

"Over my career, I have seen investment into a subsidiary on the back of a strong local regulator like the Fed or the PRA, and then the group will follow suit," says the CRO at the first global bank.

However, the first CRO recognises that the proximity of a 1.5-line team and the business units can be precisely what unnerves supervisors. They want solid evidence that the risk function is autonomous, and also that it will not be disinvested just because a business line is performing poorly: "There is always a healthy amount of scepticism around the 1.5 line because of remuneration."

Still, the senior risk manager at the large US bank thinks the 1.5 line is here to stay. They believe supervisory doubts can be allayed, as long as banks demonstrate that responsibilities are clearly defined, risk models are consistent across the lines of defence, and the 1.5 line genuinely means upscaling risk management talent.

Editing by Philip Alexander
