GLOBAL riskupdate

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# Who Will Want to be a Compliance Officer?

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# What Happened to Risk Management?

*There has been a change in risk management. Perhaps we should have seen it coming. But perhaps that is the problem. Risk management no longer sees things coming. The key change is that it is acting more and more like a regulatory construct, like a compliance function. That is not its role and should not be seen as being enough. This article expands on the trends in risk management over the last 30 years and provides a series of potential actions that firms should take.*

## The Development of Risk Management

Risk management is not new. I am sure the Romans exercised some form of risk management as they developed their building plans for domination of the world as they knew it. In many industries risk management was firmly embedded into the fabric of the business. Industries such as pharmaceutical, oil and gas and engineering, for example, would all consider the risk of the actions that they were taking. This is due to the significance of the impact of failure on their brand.

If a drug sold by a reputable pharmaceutical company is found to be faulty this can result in major loss of life and a level of claim that would certainly breach the risk appetite of any firm. Such failures must not happen and the licensing rules for the industry ensure that the levels of testing that are undertaken are commensurate with ensuring that the chance of such an event is significantly reduced. What might be considered as typical risk management is included within the regulations for the industry and so aligned to the reputational maintenance needs of the business that to ignore them would be considered completely unacceptable by both the management team, regulators and society at large.

For most of the last century techniques in this area have been improving. Generally commencing in areas which surrounded process quality they were rarely bought together into a consistent format to implement what might now be considered as enterprise risk management. However these approaches did significantly enhance the brands of these firms through attempting to ensure product quality. In terms of codification of risk management into an industry with professional standards and standardised approaches much of this followed the development of the quality industry and associated methodologies. Rarely were risk managers titled as being "risk managers". They were quality control officers and other similar sinecures.

In banking none of this happened.

## The Lag in Banking

In the 1970s we did have banking rules. Well sort of. Certainly there were licensing regimes in most countries.

These set basic requirements to support the management of fiduciary responsibility. Compliance officers really started in the 1970s as requirements became slowly more complex, but the real growth in the industry did not start until the 1980s. With the development of rules by external parties as opposed to management seeing the need for the process and choosing to design the rules themselves we get a difference in approach.

In most industries management recognised that maintaining brand values meant you do not kill people unnecessarily (unless you are an army). This inextricably leads to some form of risk management being implemented regardless of what it is called. In the banking industry senior management were too busy just making money to see the need for unnecessary additional controls. At its most basic banking and insurance operated a different general control structure.

In common current parlance the three lines of defence model was only partially implemented. Remember the first line of defence are people that do things. They need to know what they should do and be trained to do it. They need generally to be cautious and careful being reprimanded if they do something wrong. The second line of defence is there to ensure the first line of defence is operating effectively. It provides a level of control and monitoring to encourage the first line of defence to do the right thing. It neither replaces the first line of defence nor ensures that the first line of defence will not fail; instead it supports, monitors and informs. In business risk management was being developed in the second line and more importantly in the first line. In banking additional second line resources were often thought to be unnecessary and the industry incorrectly assumed that risk management was fully embedded within the first line of defence. It is only with hindsight that it became clear that this was not the case.

The development of internal audit as the third line of defence actually occurred over a similar period and paralleled these developments. The third line was normally an inspection process checking things management needed to have checked in the way they wanted them to be checked. In this case both the banking industry and other parts of the global community were actually acting in the same way.. The development of a forward looking added value internal audit function again was a 1980s development which took hold at the end of the last century. Even now in some countries internal audit is still little more than inspection with all of the consequent negative connotations. And what about senior management and their need to have effective controls to ensure that their goals and missions were achieved? Again this is 1980s language and in terms of defence we know what most senior management were doing. They were sitting on it.

As the regulators in the banking industry increasingly required discrete rules to be implemented particularly in the 1980s and 1990s this resulted in the growth of the compliance function. Since many of these rules actually related to elements of risk management, this was increasingly seen as a regulatory construct and not something that truly added value to the firm.

Risk management within our industry was in its infancy.

But it was worse than that.

## The Development of Compliance and Risk

Even in compliance there was a quality problem. Where do you get compliance officers from? The legal functions of the banks were generally staffed by legally qualified professionals who understood certain elements of legal process and documentation. In some areas they would be extremely detailed in their knowledge whereas in others that would have what might be termed as "hidden shallows". What they generally did not know was how the bank operated and processed things. Accordingly they did not want to grab this new industry as being part of their own and kept well away.

The only answer that was left for the banks was to take people from the existing business and put them into compliance. Often these were either people that were not good at the [illegible] they were doing, heading [illegible] retirement or had som[illegible] perceived personalit[illegible] meant their direc[illegible]

to recommend their transfer to this new area. Many of these people worked really hard to create their new world. Many of them were also unsuitable for this challenge. With elements of risk management being essentially delegated to a number of these compliance officers it is perhaps unsurprising that the business really operated in spite of their existence and very little real change happened. Internal audit had originally suffered with the same malaise although escaped earlier.

I recall one case from only seven years ago where in a major bank I was informed that "If you were no good at your job, or were physically or mentally disabled the obvious place to put you was internal audit." In that firm compliance did not even achieve that level of weakness.

If you place risk management into the arena of being a regulatory construct then clearly management will not take it seriously, building it into their strategy and daily way of doing business. With regret that is what happened.

## The Regulators Response

Again in the late 1970s regulators were increasingly concerned about the potential for banking failures. Interest rates were rising erratically to a peak in 1980 and massive volatility until the peak of 1982 and the subsequent decline.

As they became concerned they also realised that they did not have the right teams or rules either, so they often went outside to consultancy firms to develop their initial thoughts. These requests were to look at the areas where they were most concerned and to develop guidance as appropriate for dissemination to the industry in draft. The first set of requests was typically in the area of lending and initial guidance was created. It was however guidance and the regulators hoped it would be taken into account but compliance with these rules was not compulsory. Worse still it was a single risk set – credit risk. This was the start of the risk silos which remain part of the problem.

With the regulators issuing this guidance of course many compliance officers grasped it. However some seeing that it was only guidance purely issued it around the business and thought that by doing so they had done something useful. Of course they had not.

## The Business Imperative

The 1980s was not an easy place for banks to make money. Interest rates on average were rising so their cost of funds was definitely increasing. Customers with long terms loans would sit on them since to refinance the loans would result in a increase in rates. The economy was difficult to manage particularly in the Western world. The inability to get long term finance constrained business growth. The unwillingness of people to move housing loans constrained their ability to acquire new property, slowed the property market and also resulted in an increase of unemployment with people stuck in negative equity in the wrong places. That was the business imperative at the time. Banks needed to see what was coming and what came was a secondary bank crisis of cascading failure.

For the first time there was a convergence of the needs of the senior management team and risk management leading to both the development of risk management teams and also risk management techniques such as interest rate swaps initially developed in the early 1980s. Only then do you really get the growth of risk management as a subject but again the problem of compliance was still there. Where do the staff come from that are needed for this new area? In many cases they took staff from compliance into these new functions. Credit underwriting was clearly established so many firms took staff from there (or from credit administration) to staff these new business areas. The vision of enterprise risk management was still a long way away. For many firms it remains little more than an illusion now.

## And Today?

Now firms have large compliance departments as they continually are whipped by regulators on the loser pays principle. They have large internal audit functions which are risk based looking at areas such as efficiency for the first time (at least that is what the rules say). And of course they also have large risk management teams developing ICAAPs and ORSAs, Recovery and Resolution Plans, stress tests and ILAAs. They have models and mathematicians and they still operate in silos.

The vision of risk management is really reliant on the involvement of senior management. The goals of risk management need to be correlated to the goals and missions of the firm. Management need to understand that risk management is not separate from business; rather it is part of business. There is no such thing as credit risk, market risk or operational risk. Instead there is risk which is the real currency of the firm. Its coordinated management as set out in some of the recent inconsistent papers is as important to the business as taking deposits or lending. The maintenance of a reputation within a bank needs activity to be both profitable and to ensure that there are no surprises; that the business can weather a perfect storm better that its peers and meets the expectations of its stakeholders. Do you think risk management is there even now?

With regret the over concentration on models built using data from an interest rate declining environment combined with limited common sense will be part of the problem. The silos remain and risk management is still rarely fully embedded into the first line of defence. It is common sense but that is rarely common.

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