Implementing the blueprint for managing risk more effectively

Rebalancing the first and second lines of defense
Globally, banks are making a host of changes to get their three-lines-of-defense approach working optimally. Our survey focuses on these major areas:

- **Making the first line accountable for all risks:** Banks have stepped up their efforts to strengthen first-line accountability. And, much more so than last year, banks are using a broad range of approaches – including training, new capabilities, and revised incentives.

- **Strengthening the second line of defense:** Banks continue to add risk and compliance personnel to the second line. Critical issues about roles and responsibilities of the first and second line remain. Enterprise-wide risk management firms sit on the second line, but require new capabilities.

In prior years, banks have seen this as a choice: put an emphasis on the first or second line. Today, they realize it is about rebalancing these roles, and also considering the implications for the third line, internal audit.

Over the last seven years, EY, in collaboration with the Institute of International Finance (IIF), has monitored the industry’s progress in improving risk management through a series of annual surveys of large financial institutions globally. This year, 67 banks from 29 countries participated in the survey.

This included 23 of the 30 institutions designated as global systemically important banks (G-SIBs). Senior risk executives completed online surveys, were interviewed, or both.

The findings of this survey are presented in a series of four reports. In addition to this report on the structure of the risk function, there is an executive summary and separate reports on managing non-financial risks and building sustainable business models.
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The effectiveness of banks’ risk management is an essential element in their ability to achieve sustainable profitability. By managing their risks well, banks can cut profit volatility and reduce the likelihood of reputation damage and costs from conduct remediation and fines.

A core finding of the seventh annual global EY/IIF bank risk management survey is that banks are increasingly focusing on making the first line of defense more aware of their risk control responsibilities and enhancing their ability to perform these responsibilities.

This year’s survey highlights a broader context in which these changes have been taking place. Pre-crisis, many major banks had built up second-line control functions, while the first line (businesses) became mainly focused on revenue generation. In those institutions, first-line accountability for risk was slowly eroded. By contrast, some institutions had a strong culture of first-line accountability, but had not invested enough in the second line. When the financial crisis hit, and the regulatory response kicked in, both types of banks faced considerable pressure to strengthen the three lines of defense.

All banks are now working to make the management of risk everyone’s responsibility. The first line has to manage the risks it creates, both financial and non-financial. The second line has to be fully accountable for enterprise risk. This requires changes in the first or second line, or both. Commenting on these transformations, a banker said: “What you are seeing is a recognition of ‘I own my risk.’ “

The survey indicates there are several routes to successful risk management. Banks must rebalance roles and responsibilities across and within their three lines of defense, make individual responsibilities clear through the risk appetite and education, ensure there is an appropriate risk culture and make better use of common firmwide processes and technology platforms.

Restructuring the three lines of defense

Post-crisis, regulators in a number of countries concluded that the front line had not been sufficiently engaged in considering intrinsic risks in the business. The survey shows that lack of accountability by the first line has been viewed by G-SIBs as a significant contributory factor to the major conduct-risk failures.

The regulatory response has been relatively consistent globally. Rather than push for a different control philosophy, regulators have since shown a clear preference for a fully functioning three-lines-of-defense model – for example, internationally, in reports from the Financial Stability Board (FSB) and nationally through such requirements as Heightened Standards, from the US Office of Comptroller of the Currency, the Senior Management Regime in the UK and Europe’s Supervisory Review Evaluation Process. The focus from regulators is on individual end-to-end accountability in the first line and on clear independent control functions for all risks.

A global wave of change

Banks are no longer rethinking the framework of a three-lines-of-defense approach. Instead, they are continuing to implement change – recognizing that there is a long road ahead.

Initially, some focused on redefining the principles of accountability for risk. As an executive recalls: “We went back to first principles and the taxonomy of risks, by considering the owner and steward for each risk.” What became clear in many banks was that to discharge their responsibilities, the first line needed more control capabilities and a better understanding of the risks they should own. This led banks to move some control functions to the first line from the second. In one executive’s view: “The first line of defense has to do a bit more and the second line a bit less.” Other banks with perceived weaknesses in managing aggregate risks built out second-line risk and compliance groups further. For some, until recently, this was viewed as an either/or choice. Today, banks recognize that it is all about rebalancing the first and second lines, such that both are fully able to perform their roles, supported by the third line, internal audit.

Not all banks are at the same point in the process of implementing change. The majority still feel they have work ahead, with 60% of all responding banks (52% of G-SIBs and 64% of non-G-SIBs) saying they are still in the process of changing their three lines of defense. The scale of change varies by institution. As one respondent said: “Did we fundamentally change our approach? No. Did we work to clarify some areas that needed clarification? Yes.” Such change, inevitably, will be felt across all three lines over time.
Multiple factors are driving these changes, as shown in Exhibit 1.

**Increasing first-line accountability**

Last year’s survey presented clear evidence that banks had started to make changes to strengthen first-line accountability for risk. This trend has accelerated over the past year, with banks adopting a broader range of changes to drive accountability – as one banker put it, “We use all possible levers.”

- Nearly three-quarters of respondents were providing the first line with training on risk, as well as clarifying first-line responsibilities for risk appetite.
- About half were establishing new control functions in the first line and increasing their focus on forward-looking risk.
- Approximately one-third changed the accountability of business-line heads to make their risk responsibilities clearer.

Strengthening first-line accountability will take time and require a re-education of those in the business units. The second line has to support the first line. “We are making more tools and information available to the first line to support them in making decisions,” said one executive.

Banks have been strengthening their first lines to better manage non-financial risks, and identified critical factors to delivering first-line accountability (see Exhibit 2).

- Among G-SIBs, 63% listed increasing first-line accountability as an action they were taking to reinforce conduct risk management.
- Given options for how management would control costs going forward, 81% – the biggest proportion, by far – cited improving the capabilities of first-line personnel to control conduct risk.
- Enhancing first-line policies was cited by 62% as an area where they expected management to invest to help control conduct risk.
Implementing the blueprint for managing risk more effectively

Chief risk officer (CRO) structures vary depending on the complexity of the firm. The most prevalent structure noted by respondents – 43% of G-SIBs and 37% of non-G-SIBs – was a primary reporting line to functional heads within the group risk function who report to the group CRO, with secondary reporting lines to the CROs at the business-line, regional and legal-entity levels (see Exhibit 3).

Given the burden on firms to boost their return on equity (ROE), risk functions are struggling to reduce or contain costs. Some have stripped out layers such as divisional CROs and centralized functions, for example, model validation. However, pressure from regulators to enhance subsidiary governance in several jurisdictions is adding to layers in some areas.

Exhibit 2: Important factors for first-line risk accountability

<table>
<thead>
<tr>
<th>Factors</th>
<th>Average Ranking</th>
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<tbody>
<tr>
<td>First-line risk management skills and capabilities</td>
<td>2.6</td>
</tr>
<tr>
<td>Having the right incentives in place</td>
<td>3.2</td>
</tr>
<tr>
<td>Clearly defined processes and activities</td>
<td>2.6</td>
</tr>
<tr>
<td>Group risk appetite allocated at a business line</td>
<td>3.5</td>
</tr>
<tr>
<td>Control capability in the first line</td>
<td>3.5</td>
</tr>
<tr>
<td>Moving some risk management activities from the first to the second line</td>
<td>5.5</td>
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</tbody>
</table>

“The first line must understand risks and recognize that risk is not always where it is believed to be – and must apply controls for their own health.”

– Risk executive

Changes to reporting lines in risk functions
Adapting the structure of risk and compliance functions

Across the first and second lines, the size, focus and effectiveness of risk and compliance groups continues to evolve.

Risk function plays a critical role linking strategy and risk

The risk function contributes to banks’ long-term sustainable profitability in a number of ways. Survey respondents named these as the most significant:

- Linking strategy and risk appetite (cited by 72%)
- Identifying aggregate emerging and forward-looking risks (57%)
- Ensuring an effective risk management framework (47%)
- Helping influence firm risk culture and behavior (45%)

The link to strategy is critical given the emphasis regulators have placed on managing strategic risk more effectively and having a robust strategic planning process that links to capital, liquidity, and recovery and resolution. It also highlights risk’s essential input into decisions to evolve the banks’ business portfolio, geographic reach, and product and service offerings. Risk functions need to assess how far risk appetite is embedded in business decisions – an area where the industry recognizes that more needs to be done.

Banks are still finding it hard to meet these objectives without adding more risk personnel to the first and second lines. In fact, they are doing so more aggressively than ever: 55% and 40%, respectively, reported that their risk headcount had risen in second- and first-line risk in the past year. With aspirations to reduce costs, 15% reported a decline in risk personnel, compared with 8% in each of the two previous years. However, the upward trend will likely continue overall, as the majority of firms expect to add more professionals to headcount in the next year.

One clear message from interviews with senior risk leaders was that regulatory change continues to drive headcount increases in risk functions of some banks, with no sign of abatement given changing regulatory requirements. Another message was that achieving greater efficiency will require significant spend on IT and data, particularly sourcing data straight through from the front office. However, banks are finding it difficult to find the necessary budgets in the short term, given that these projects have longer-term payoffs.

“The business lines are enhancing the control environment by investing in people to be more dedicated to product controls and performance, operational and legal risks.”

– Banking executive

Exhibit 3: Description of reporting lines for the risk function

<table>
<thead>
<tr>
<th>Reporting Line</th>
<th>Overall</th>
<th>G-SIB</th>
<th>Non-G-SIB</th>
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</thead>
<tbody>
<tr>
<td>Primary reporting line to functional heads within the group risk function who report to the group CRO, with secondary reporting lines to business line (divisional) CROs/regional CROs/legal entity CROs</td>
<td>39%</td>
<td>43%</td>
<td>37%</td>
</tr>
<tr>
<td>Primary reporting line to business line CROs who report to the group CRO with secondary reporting lines to functional heads within the group risk function</td>
<td>19%</td>
<td>21%</td>
<td>14%</td>
</tr>
<tr>
<td>Primary reporting line to functional heads within the entity risk function who report to the entity CRO who reports to the group CRO</td>
<td>14%</td>
<td>13%</td>
<td>14%</td>
</tr>
<tr>
<td>Primary reporting line to functional heads within the regional risk function who report to the region CRO who reports to the group CRO, with secondary reporting lines to business line CROs and legal entity CROs</td>
<td>5%</td>
<td>14%</td>
<td>24%</td>
</tr>
<tr>
<td>Other</td>
<td>14%</td>
<td>29%</td>
<td></td>
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</tbody>
</table>
Compliance function is becoming more risk-oriented

Compliance groups are on a journey, following major control failures. There is a greater focus on the need to have a clear second line to review compliance risks. Showing commitment to the importance of the compliance function, many have altered reporting structures for chief compliance officers (CCOs) in an effort to enhance the CCO’s stature. As an executive explained, “With the CRO and CCO having the same power and responsibility, the second line has been empowered by the board.” Few CCOs report to the head of legal anymore, while 73% of responding firms say that their CCOs report to the CEO or CRO (see Exhibit 4). This is part of banks’ reconfiguration of their three lines of defense, driven by regulatory pressure for compliance to have a fully independent role within the firm.

In interviews, a number of bank executives noted that the reporting lines are part of a broader shift toward a more risk-based and less legalistic mindset. More recently, some firms have been determining how to better align compliance and operational risk groups or to strengthen compliance oversight at the board level, and seeking ways to use more consistent tools and frameworks across these groups where possible. However, some banks said that although compliance needs to become more risk-focused, in their institutions, the staff still largely has a legal mindset; these banks are not as far along the change journey as others.

The compliance function continues to grow alongside risk. Almost four in five (78%) banks surveyed indicated that the number of compliance people increased in the last 12 months, and about two-thirds (65%) expect further increases in the next 12 months. A small minority of G-SIBs (14%) expect to decrease compliance in the year ahead.

Clarifying responsibilities across lines

A critical component of enhancing the effectiveness of the three-lines model is clarifying and properly communicating the roles of the first and second lines.

No industry standard on where roles should reside

Given the evolution taking place in roles and responsibilities, views differ across the industry as to what should be done by the first or second line. Four in five (80%) respondents say that their first line performs business-line activity controls, while 80%–90% say that their second line owns key risk policy, performs control testing and designs the control framework. The industry is split on who performs control monitoring, with 49% and 51% placing it in the first and second line, respectively.

Across the industry, however, there is greater agreement on where risk activities should take place in the corporate/institutional business and the small-business/retail side. Generally, the first line owns these activities for the corporate/institutional businesses, whereas the majority say that the second line owns them for small-business/retail businesses (see Exhibit 5).

Clarifying, communicating and training against roles and responsibilities is challenging. Increasingly, firms are using governing principles to drive change. In the past two years, 55% of responding banks have redefined their governing principles and, of those, 91% say that this redefinition has resulted in operating-model changes that facilitate greater first-line accountability for risk. Inevitably, as roles and activities change in the first and second line, the third line — internal audit — also will be affected eventually.
Rebalancing the first and second lines of defense

Similarly, firms have been focusing on how best to conduct testing, e.g., model validation or compliance processes, in the first or second line. Over the years since the crisis, testing functions have sprung up across the lines, with little, if any, effort to ensure consistency or have the work performed efficiently. This is changing. About a third (32%) of firms have already created a centralized testing team, and more (37%) have established central teams for some aspects of testing. Almost a fifth (19%) more believe in such an approach, but are either unsure how best to do it or are still in the planning stage. Only 12% said they had no intention of doing so.

Firmwide processes and tools underpin an effective three-lines-of-defense approach

Alignment on roles across and between the three lines of defense may be critical, but so, too, is the adoption of common firmwide risk-and-control tools and processes.

Respondents cited several factors driving a clear trend toward firmwide approaches (see Exhibit 6). However, these vary by region. For example, regulatory pressure is driving banks

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“We have set expectations of what percentage of problems should be identified by each line of defense. Deviation from these expectations leads to good conversations that bring life to the three-lines-of-defense responsibilities.”

— Bank executive

Exhibit 5: Banks generally agree where risk activities should take place

Control and testing roles are particularly challenging

There is no single model for designing first-line control functions. Over the years, firms adapted their three lines organically, with some establishing 1(a) and 1(b) structures, in which controls are set up in 1(b) in the businesses to perform functions akin to those associated with the second line (monitoring, for example). One banker stated that in the long term 1(b) should be fully integrated into the business line.

In recent years, some banks have also created separate lines within the second line — so-called 2 (a) and 2(b) lines. This has partly been a response to regulatory pressure regarding the independence of second-line functions, such as compliance, and questions over the independent control of legal and IT.

In some cases, these “mini-lines” have created confusion and undermined accountability. Due to regulatory pressure, some banks have focused on determining the role of individuals and groups in these lines and where necessary have made changes to reporting lines to more clearly delineate roles.

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central to these efforts, with 72% providing training to the first line to enhance accountability and 71% improving training to better control conduct risks.

The bottom line: risk and control structures will remain a challenge for banks

The adoption of firmwide approaches is not uniform across the industry. Many firms have fully or mostly implemented common risk identification (95%); risk-and-control risk assessments (92%); a process, risk and control taxonomy (81%); and common key-indicator reporting practices (70%). These are key foundational elements of a common approach.

Issues management processes remain a challenge, in part because of suboptimal governance-risk-and-control system implementation. Indeed, a large majority of respondents have not started or only partially begun implementing common data-analytic processes (63%) and technology platforms (60%).

Firms’ journeys to implement risk appetite frameworks properly – driving them down into the operations and addressing non-financial risks – also play a crucial role in reinforcing the three-lines-of-defense approach. Firmwide risk culture initiatives are important. As one respondent explained: “Risk appetite and risk culture are the big thematic endeavors that help the first line wake up to their responsibilities so they are willing to invest in the [necessary] capabilities.” Training is

most prominently in Europe, where it was cited by 53% of respondents, which is far more than in Africa/Middle East, Asia-Pacific, Latin America and North America. In contrast, North American banks were much more likely (77%) to cite the desire to better leverage risk assessments across the firm as a driver compared with other regions.

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The bottom line: risk and control structures will remain a challenge for banks

Risk management structures continue to evolve as banks seek the most effective balance of roles and responsibilities across their three lines of defense. Getting the first line fully engaged in managing risks, including conduct risks, is essential, but changes are needed in other areas, such as incentives and risk appetite accountability. Greater ownership by the businesses of risks attached to individual decisions will make the second-line control of aggregate risk more effective.

However, banks know they cannot simply keep adding headcount to better manage risk. In some areas, this may be necessary – for example, to properly staff controls in the first line or better manage non-financial risks in the second line. But depressed bank profitability will not support such a simplistic approach, long term. Common firmwide approaches, better technology and more advanced data analytics are essential, as are properly implemented centralized teams for common, repeatable tasks, such as testing. Getting these right will allow firms to depend less on headcount and more on standardized, dependable techniques and processes. Ultimately, that is the only way to deliver the right risk outcomes cost-effectively.
“Rather than increase the number of people in the second line, it would be more efficient to enhance systems and data, and more clearly define roles.”

— Banking executive
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Research methodology and demographics

EY surveyed IIF member firms and other top banks in each region, in conjunction with the IIF, from April to July 2016. Participating banks’ CROs or other senior risk executives were interviewed by EY or completed an online survey, or both. In total, 67 firms across 29 countries participated. The charts in this report display data for banks that completed the quantitative survey, while the text includes information gleaned from both the quantitative survey and qualitative interviews.

Participating banks are listed below by geographic region. An asterisk after the bank name indicates that it is one of the 23 G-SIBs that participated. Of the others, 25 identified their bank as a domestic G-SIB. The firms that completed the online survey represented a range of asset size (as of 31 December 2015) from 7% with US$2 trillion or more to 17% with US$100b or less; the largest percentage (35%) was US$100b–US$499b. Most (88%) of the institutions operated in four or more countries, with 22% operating in more than 50 countries. Most (62%) viewed their institution primarily as a universal bank, with 23% and 10% viewing their institutions as a primary retail and commercial bank or investment bank, respectively.
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* G-SIB in 2015 FSB list

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