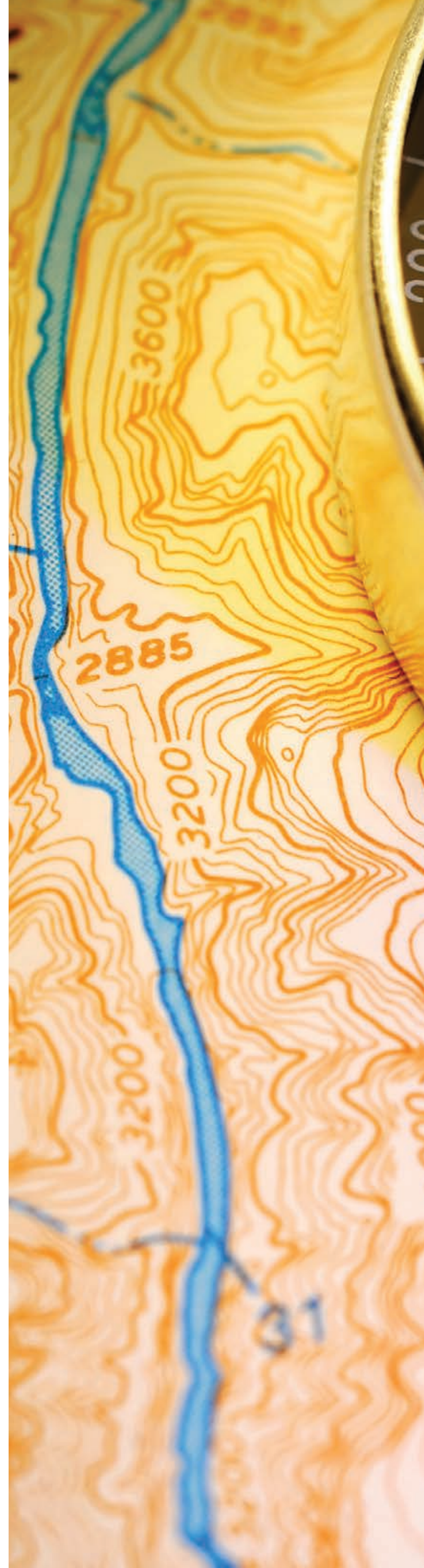
KEEPING YOUR RISK REVIEW GROUPS ON MISSION

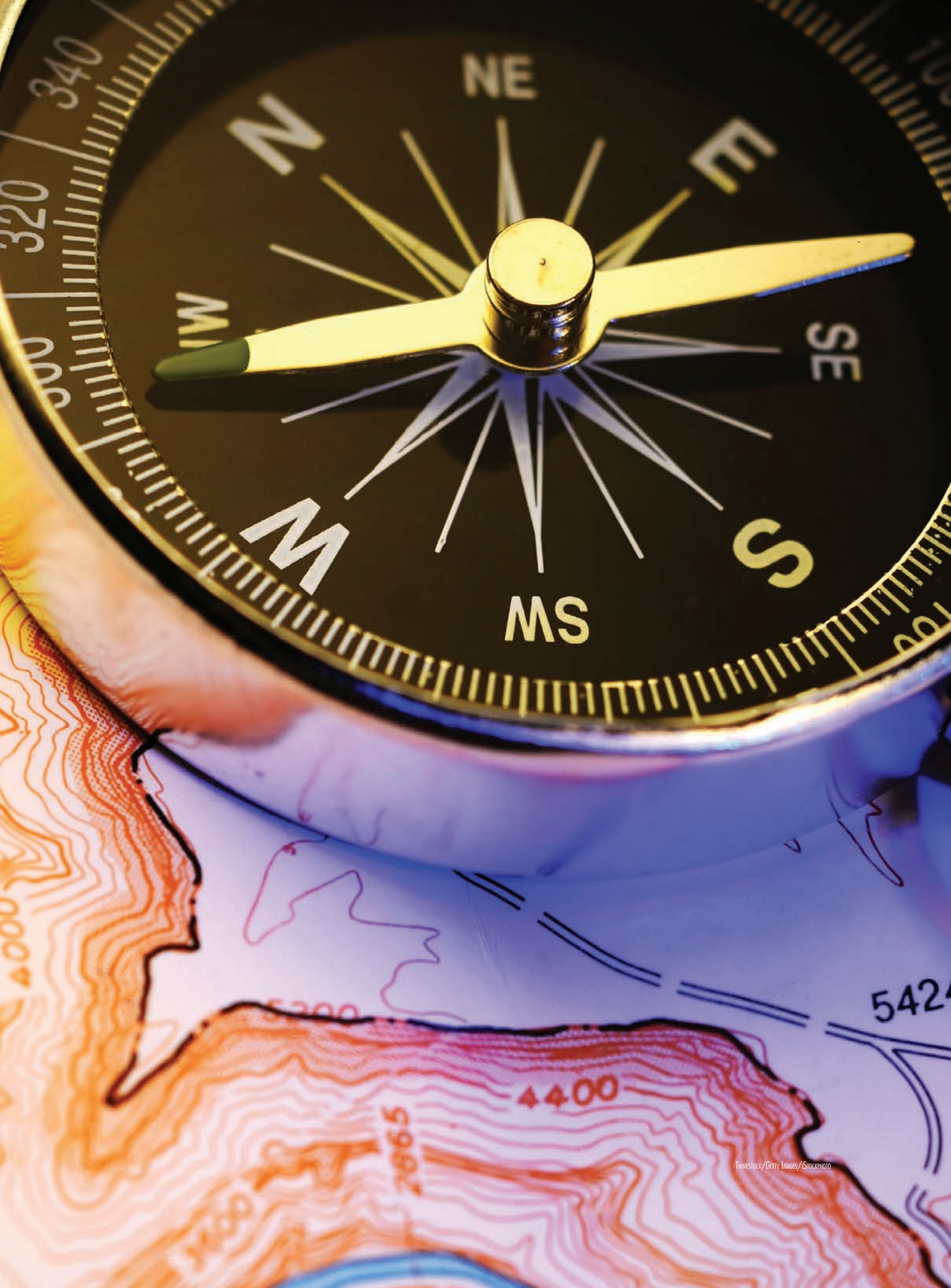
It's important for risk review groups to stay relevant and strong, even during the good times.

BY DAVE GIBBONS

INDEPENDENT RISK REVIEW groups—such as credit risk review, internal audit, compliance testing, and model validation—play a critical role in a bank's overall risk management program. Their job is to assess the risks and risk controls of the institution independently and systematically, and to report their findings directly to the board of directors.

Acting as the eyes and ears of the board on behalf of shareholders and depositors, these review groups are the experts at sizing up outsized risks, adverse trends, risk management





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weaknesses, and just plain inappropriate behavior. They can comment authoritatively on the effectiveness of the people, processes, and programs in place to control risks. Bank supervisors rely heavily on their work and are raising expectations for strong audit and risk review functions.

Unfortunately, the effectiveness of risk review groups has tended to ebb and flow with the business cycle. The focus, importance, and clout of these vital groups tend to wane in good times, only to be revitalized after problems have occurred. It is then that they are accused of missing the boat—and rightly so. For a variety of reasons, risky behavior and activities are often missed, de-emphasized, or poorly communicated during the good part of the cycle, resulting in what appears, after the fact, to be tacit approval.

For the most part, bank boards and their key committees have refocused, reinvigorated, and re-empowered their risk review groups in the aftermath of the financial crisis. Their next challenge is to sustain their effectiveness going forward. What lessons should boards glean from recent experience and historical trends?

- **Regularly reinforce mission expectations.** As the business cycle strengthens, it's common for risk review groups to come under pressure to add value to the organization. Alarm bells should go off if the mission drifts from policing to consulting to collaborating. The board can refocus risk review squarely on its job of serving as an independent check on risks and risk controls. Over the course of this business cycle, boards will surely hear their business leaders complain again that control functions like internal audit and credit review "add no value to my business." To that, the appropriate response must be a history lesson and a reminder that short memories can be fatal to financial institutions. Groups that are intended to put a check on excesses should not be mistaken for profit centers. If they are doing their job well, they are adding to the value of the business overall.
- **Manage Stockholm Syndrome.** The propensity to empathize and associate with one's captor can manifest in a number of ways that eventually undermine independent thinking, communications, and action. Examples include acceptance of weak risk selection criteria, underwriting, or pricing because of peer behavior, competitive or earnings pressures, or a disregard for the importance of control deficiencies at a time when the business is doing well. Other examples may include downplaying issues so as not to rock the boat or blindly accepting "the way things are done." For example, credit review, audit, and other control functions should review not only whether policies are being followed, but also whether they are appropriate. Periodically rotating staff or audit managers and demanding that working papers and review conclusions be seen by qualified persons not associated with the particular audit can add fresh perspective and ensure that independent risk review leaders and staff are not embracing the status quo.

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- **Demand clear, candid communication.** Risk review groups' communications to senior management and the board need to be clear and focused on conclusions. Over-engineered dashboards and long lists of facts and data can obscure rather than illuminate current and emerging risks. When this happens, there is the risk that data and facts will be reported without critical analysis and opinion as to root causes, implications, and urgency.

To govern effectively, board members need to regularly reinforce their expectations for clarity, candor, and precision when it comes to communication about risks and controls. They shouldn't tolerate having to dig through reports to understand the issues, what these issues mean from a risk standpoint, why they are occurring, and what needs to be done to resolve them; executive summaries should spell out the implications. A good report will answer the questions why and what does it mean, before they get asked. Board members can encourage candor by asking for discussions with their independent risk review leaders in executive session.

The board, the CEO, and the chief risk officer need to be unambiguous in their support of the mission and the operation of risk review groups.

- **Avoid confusing performance with risk.** As we saw during the housing crisis and other previous economic disturbances, risky behavior is often masked by performance on the cycle's upside, but it becomes a source of problems on the downside. From oil-patch and agricultural lending to highly leveraged transactions and commercial real estate exposure, we have seen this pattern for decades. Credit review and audit reports must underscore the risks despite how portfolios and businesses are currently performing. Boards and executive management must make it clear that risk management and control behavior cannot be compromised because of short-term performance. Requiring the risk management and control rating to be separated from the rating for the amount of risk will help.
- **Carefully review staffing and budget constraints.** Risk review can't be effective unless appropriately staffed. Yet staff control functions are often the first targets of expense cuts and can come under pressure at exactly the wrong time. When the cycle is yielding diminishing returns on risk is not the time to accept that savings should be reaped from control functions. Demanding that these groups do more with less undermines and confuses their mission. The board must question audit and risk review budgets that don't account for the expense associated with having the right expertise and experience.
- **Regularly reinforce your risk control culture and attitude.** A bank's tone at the top regarding risk and controls is of utmost importance. The board, the CEO, and the chief risk officer need to be unambiguous in their support of the mission and the operation of risk review groups. They should make it clear that they expect instances of poor risk management or inadequate controls to be corrected in a timely manner and at the root cause level, even in good times. When corrections by management are not timely or effective, or when there are repeat problems or recalcitrance, boards should demand an explanation. Of course, performance on audits, credit risk reviews, and other independent risk reviews, including regulatory examinations, must be factored into both performance expectations and compensation. The board must be clear in its expectation that risk review groups should help the board fulfill its duties.

As business conditions improve, natural pressures to drive revenue and manage expenses will return, bringing with them heightened risk. Independent risk review groups can't be strong and effective if they change with the economic cycle. The good news is that memories of the last crisis are so fresh that boards and their risk-related committees are in a good place with their risk review groups. Many, if not most, have been rebuilt, refocused, and re-empowered. Boards and their risk and control committees should be unequivocal in their support for risk review and in their demands for steady mission execution, thoroughness, and candor throughout the cycle. ❖

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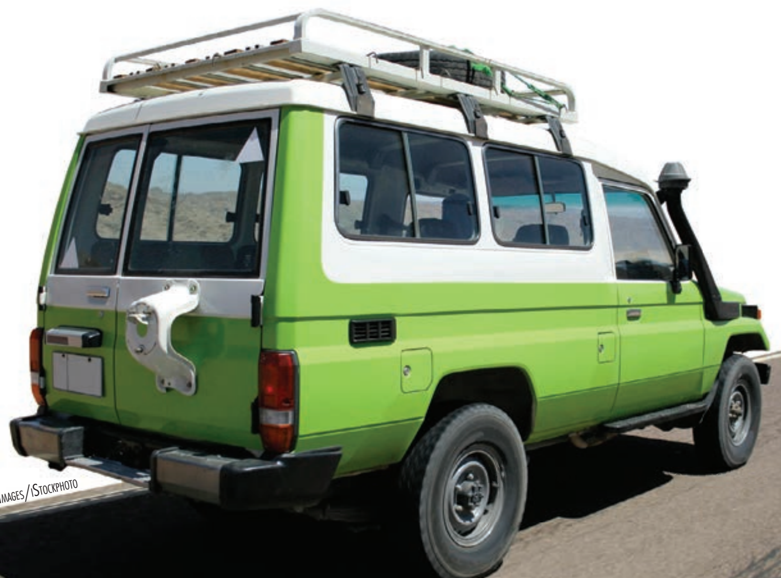

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