



Who Needs Risk Management?

By Kevin Watson, AuditOne LLC

As a bank director, we may be wondering why we ever bothered to spend money on risk managers and internal auditors, especially when they didn't protect us from painful losses during the recent hurricane that is pounding our banks and our industries. Since the storm's path is very wide, our bank most likely has suffered some life threatening problems such as loan charge-offs or even some operational or compliance problems such as with BSA, CRA or wire transfer breakdowns. Why didn't risk management and internal audit protect us from these events? This column will address those concerns.

In regard to the worthiness of risk management and internal audit I ask you to consider what it would be like to run a financial institution without those components. Certainly expenses would be lower in the short run. We could reduce payroll by eliminating internal risk management and audit positions along with the ridiculously high benefit and tax costs associated with each employee. For that matter, why bother with internal controls at all? They slow things down and are bothersome when we're trying to get our work done or to make our customer satisfied. Let's get rid of internal controls and make as much money as fast as we can.

Seriously, we would then need to be prepared to run as fast as we can to get away with our pocketbooks and pride before the mud hits the fan. Without internal controls the likelihood and impact of fraud increases rapidly as does the likelihood of wasteful spending and poor lending decisions. Also, it's only a matter of time before the government serves us with a consent order to put the controls back in place.

Now that we've decided we need to keep most of those bothersome controls in place, how are we going to make certain they are designed effectively and efficiently, actually in place, and are functioning as we want them to? That's the job of internal audit. Internal audit needs to let us know those instances when our controls are not working, before something really bad happens.

Why then, do we need a risk manager? The answer is that the risk manager can actually save us money by deploying our control resources and internal audit budget toward those corners of the bank that need it most. Also there is a trade-off in the amount to be spent versus the potential amount of loss or severity of compliance violation. Frankly, we don't need to audit every activity every year. On the other hand, some activities should be audited more often than once each year.

For example, our largest risk is most likely our loan portfolio and most likely we should have it reviewed more often than once per year. As we recently experienced, credit quality can go downhill quickly and the earlier we notice it, the sooner we can adjust our lending practices and ramp up collection efforts. The early bird does get the worm when it comes to collecting on bad debt.

Risk management can also save us in ways that aren't easy to appreciate. For example, an effective risk manager will point out to us where we have concentration risk. Concentration risk can be especially deadly. For example, if too much of our capital is deployed in one industry, product, geographic area, broker, or type of customer, we could lose everything if that segment suffers a failure. Certainly, that is what happened to many mortgage and construction lenders in recent months. While we may not have much of a choice in regards to geographic area or business line, we do need to know the risks of being hit by that perfect storm.

Risk management and internal audit then, are much like insurance. Would you dare consider owning an expensive car without insurance or self insuring yourself against medical problems? We hate to write that insurance check since it doesn't directly lead to increased revenues. However, spent wisely, these checks help to keep our total costs to a level we can live with. Without insurance in the form of risk management and internal audit, during a perfect storm our costs would most likely sink our boat.

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