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THREE LINES OF DEFENCE IN RISK MANAGEMENT
Clear thinking is needed

Board and executive management are being placed under increasing pressure to address 'the ills of the past.' The regulator has focused intentionally on the "tone from the top", "culture change" and "conduct risk management" with expectations for long lists of key risk indicators. Although this is not an unreasonable start, and well-intentioned, this nearly singular top-down focus towards managing risks has stopped being helpful to businesses.

Regulators and businesses have come to the realisation that to achieve real change to risk management and culture, the hearts and minds of those on the ground need to be engaged. As firms recognise this they are revisiting the use of the three lines of defence risk management model. In recent discussions, firms have mentioned to us that they are revisiting the model and how they use it in practice. Whilst some say the model is too simplistic, we believe its simplicity may actually be its strength and its proper adoption might well lead to sustainable, cost effective risk management programmes.

This article provides observations on the three lines of defence, where it has gone wrong, and why it makes good business sense to revisit the fundamentals.

A Brief Summary

The first line: Operational Business units

The first line brings risks into the organisation. These revenue producers bring in 'risky' products and clients in their efforts to deliver desired financial results. What we frequently fail to see is the first line 'hands-on' producers really grasping the risk/reward trade off of the activities they undertake; they don't recognise the resources required to investigate new products, new legal entity structures, new jurisdictions, or clients from high risk jurisdictions.

Business line senior management are responsible for ensuring they understand and manage the risks effectively; i.e. have the right systems and controls been put

in place to manage their business within the risk appetite set by the Board. Most importantly, they need to ask themselves – 'How do they know that what they think is happening in their business actually is?' This leads to the question who tells them if things have gone awry: their own business leaders or compliance?

The second line: Risk Management units

The second line of defence maintains the risk management framework, provides advisory services, conducts horizon scanning and monitors the first line's risk management systems and controls. The function is also responsible for managing regulatory relationships, ensuring policies and procedures are in place, assisting with education/training programmes (though the first line should provide ongoing event based awareness programmes), and reporting the company's compliance with the risk appetite to the senior executives and the board.

The third line: Audit units

Independence is the distinguishing feature of the third line. Audit is not involved in any of the day to day operations of a company. Its responsibility is to perform period reviews of the business and infrastructure areas as set out in an annual audit plan (covering the audit universe on a three year cycle). Audit will also be called in to investigate breakdowns in the internal risk systems and controls. Senior managers are also able to call on the function to conduct one off reviews to gain assurance that all controls are working as intended. The Audit function provides reporting to the Audit Committee of the Board.

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Whose line is it anyway?

In situations where the three lines of defence model has been unsuccessful, one of the main reasons has tended to be the lack of clarity of responsibilities between the first and second lines. In practice, while senior executives generally understand the model, often the business producers working under them do not fully appreciate and consider the risks they might be undertaking. Their outlook can often be, "at the end of the day I need to make my revenue targets". It is important to recognise that firms are seeking 'good quality revenues' that fall within their risk appetite not just any revenues. The dependence on the second line to 'bless' new deals, transaction types and customers is ill founded. The business is best positioned to

make those decisions for itself, and these need to be escalated within the first line for decision-making rather than to the second line.

First line units, particularly the managerial tiers, need to be better educated about risks, about the costs of second line support (not an unlimited resource) and held accountable for supervising the risks of the business that is brought in from their staff. Executives must incorporate an element of oversight so they are confident of what is going on at the coalface and help avoid wasted resources. Second line units need to work in an equal partnership with the first line, alerting them to emerging events in the regulatory and risk space, giving them guidance on new products and services, where risks could arise, and serving as a sounding board. They should not allow themselves to be put in the position of decision maker on specific situations – that is a first line responsibility.

The bottom line

Weak systems and controls that fail to mitigate risks at the earliest possible stage will add substantial costs further on down the line without solving the root cause issues. Firms need to place explicit emphasis on managing risk through the first line units that are facing those risks and bringing in new business. This makes sense because trying to manage risk primarily through the second line is like back-seat driving. The second line is removed from difficulties that arise in daily transactions and operations. It is unable to see exactly what the business is facing, cannot identify risk trends, and does not have enough first-hand information or time to react to a "crash".

When a crash does occur, the response tends to be introducing more controls and checklists and have the second line do more. Wrong answer. The first line needs to take ownership and think about what they can do better, consider whether they have identified and continue to monitor the key controls, work out what should have alerted them to the situation that emerged and, importantly, establish how they might be able to know earlier and do better next time.

As case in point, US/UK regulators have required several firms to add thousands of additional employees in the second line to address anti-money laundering and sanctions failings at significant costs. Whilst a great deal of work has been undertaken, the question remains as to whether the first line will be able to spot similar issues as they emerge in the future, rather than when it is too late. This is indeed the goal: a sustainable risk management programme that ensures issues are identified early on.

Managing costs effectively is increasingly imperative in financial services. Placing controls within the first line makes good business sense because it is the best way to pre-empt high remedial costs and protect the firm's brand. To maximise the benefits of your risk management framework and ensure a sustainable cost model stress these practices:

- Clearly define risk management responsibilities between the first and second line with an increased meaningful ownership by the first line.
- Provide periodic education and ongoing awareness session for the first line so that they understand and can identify potential risks more clearly. Encourage them to escalate issues quickly.
- Provide end to end process education sessions on key risk areas to the first line, ensuring the risk/reward and revenue/cost trade-offs are explicitly covered. (The authors ran one of these recently on anti-money laundering and the first line eliminated 30% of its client base because "it was not worth it".)
- Explicitly incorporate risk system and control procedures into first line procedures and produce relevant management information on key control points.
- Define explicit monitoring and escalation processes for first line management to manage and mitigate risks, including enforcement and disciplinary measures.
- Encourage communication and information sharing with counterparts across the first and second line groups. This should include quick escalation access. Rather than an issue being considered by numerous first and second line people, take it to the top of the business function quickly.
- Develop effective second line functions who will ask questions, challenge and at the same time support the company's business goals.
- Ensure the third line is appropriately resourced and understands the business so that its findings are helpful in creating a sustainable, risk aware environment. Encourage senior managers to use third line functions to conduct one-off reviews in support of their goals.

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It seems clear that the regulatory spotlights on the Board and senior executives will continue. Ultimately they are accountable for ensuring the company has an appropriate risk appetite and that the business operates within that appetite. That being said, they do need to push accountability down into the operations of the business and the best way of doing so is to adopt a robust 3 line of defence operating model. The missing part in the past has been real first line ownership and understanding of those risks. If firms can get the first line more actively engaged, and its senior managers keep asking themselves, "How do I know what is going on? How do I know if my business has the right systems and controls in place to monitor those risks?", then their level of confidence should increase.

There are plenty of discussions underway of about three, five, seven lines of defence. In effect, it is about clear accountabilities and understanding. Sometimes keeping things simple really is an excellent idea.

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Jeannette Lichner
Senior Managing Director
+44(0)20 3727 1316
jeannette.lichner@fticonsulting.com

Suzette Diaz
Consultant
+44 (0)20 3727 1739
suzette.diaz@fticonsulting.com

Jo Franklin
Marketing Manager
+44 (0)20 3727 1762
jo.franklin@fticonsulting.com

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