

# Pitfall of Current three Lines of Defence Definition in Financial Service Sector

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## *Abstract*

*Current model of three lines of defence used widely in financial, insurance sector and in corporate governance has proven, especially during the financial crisis, not a very efficient. The “three lines of defence model” has been there for decades to model the interaction between the primary revenue generation and internal controls. Recently it has been shaped slightly differently by the regulators which changed even further the construction of this model. This paper will explore different organizational strategy which is a modification of the embedded three lines of defence model by proposing that all the controls are primarily own by the first line of defence.*

**Keywords:** *corporate governance, business strategy, organizational structure, financial institution, risk management.*

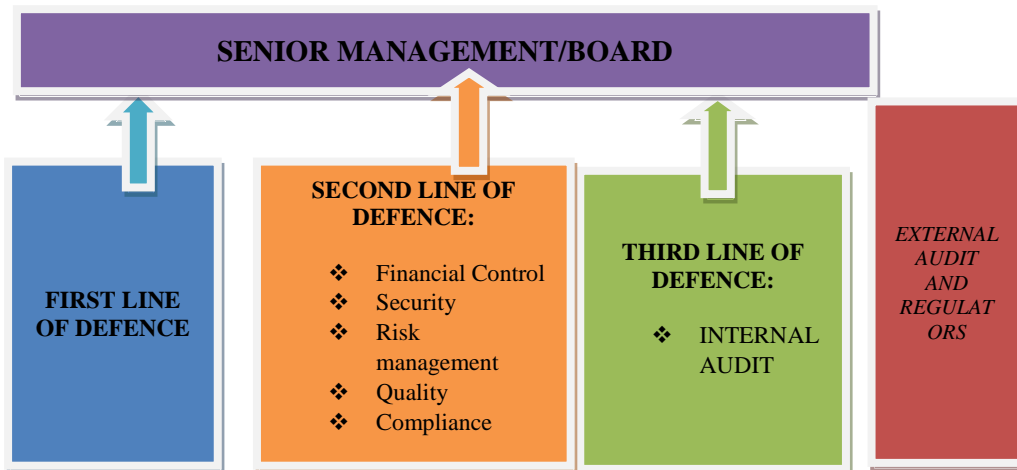
**JEL classification:** M19, G29

## **1. Introduction: Governance model and three lines of defence model**

Corporate governance structure has been around since the '90, stemming from battle strategies which required multiple lines of defence to protect positions they hold. It implies structuring the organization in three lines with very well establish roles and responsibilities each of them defending each other. The description below is a general description which can be applied to both large corporation, financial sector and insurance.

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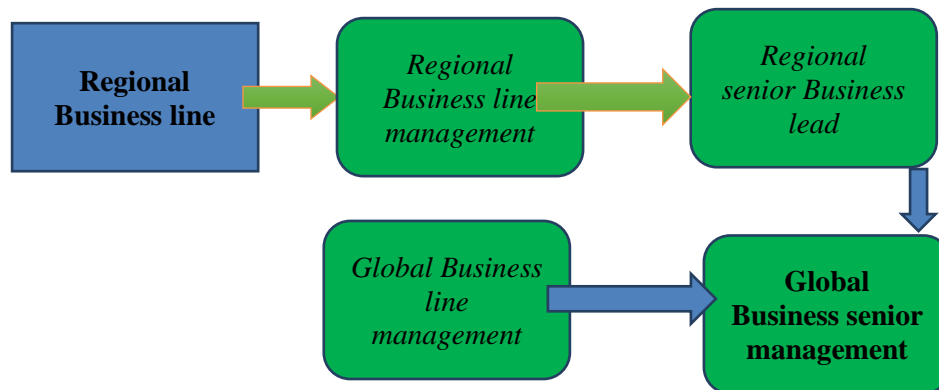
**Figure 1. Three lines of defence schematic representation**

### 1.1. First line of defence

This is primarily the lines of business which have the following main characteristics:

- These departments are the main revenue generation and they are in continuous interaction with the client
- These departments shape the business strategy and decide the main investments venues
- They are the primary owner of the risk and deploy strategies to efficiently risk manage all types of risk.

In large multinational organizations, these are organized by types of business and region with reporting lines that span both at the regional and global level in what it known as matrix management. This means that the regional business line has a direct manager the regional senior business lead as well the global business line management (Epstein, Buhovac, 2006).



**Figure 2. Matrix representation of Regional/Global business**

## 1.2. Second line of defence

Second line of defence are the functions that advise, set policies and monitor the effectiveness of the risk and controls conducted by the first line of defence.

The main characteristic of the second line of defence are:

- ❖ They are support functions for the first line of defence, normally working in partnership with first line of defence to set the risk appetite, set best practice in terms of governance and risk management.
- ❖ These departments can set additional controls to support the first line of defence in effectively manage the risk, especially when it comes in terms of risk management across business lines
- ❖ These departments are cost centres and never a revenue generation and have very limited interaction to the clients, but extensive interactions with regulators, auditors and senior management.

Typical departments in the second line of defence are financial controls, quality insurance, risk management, security, compliance etc. These departments are normally mirroring the way the business is organized such that there is a one to one mapping between the first line of defence to second line of defence (Murray-Webster, 2010). However, for any efficient organization there is the requirement that the second line has specialized function that have as target the controls and specifications across all business and not looking at one business in isolation. For example, it can be that all the business are within their risk appetite, but looking across all the business at the regional or global level the risk appetite is exceeded.

In order to be efficient, the second line of defence needs to fulfil few main conditions:

- ✓ **The functions need to be independent.** The independence of the second line of defence is essential in proper management and they need to have an established status in the organization with appropriate authority and standing. Any bias towards the first line of defence in terms of compensation, management structure can transform the second line of defence in a completely inefficient structure and promotes conflict of interest within the organization. This ensure that the function can have a different opinion when contrasted with the first line of defence as they represent very different angles: first line of defence skewed towards revenue generation and acceleration of business and second line of defence making sure that all the conditions are met for the business to be able to accelerate. Although the second line of defence is a partner of the business, it needs to make sure that there are enough financial resources allocated to the acceleration of

business and all the infrastructure is ready to handle the increase in business.

- ✓ **Business needs to promote best practices into the second lines of defence.** Being aware of the importance of the second line of defence, the business needs to allocate enough financial resources to attract and retain the best talent into the support functions. The resources to be provided to these functions should be both sufficient and appropriate to ensure that second line of defence can operate within the organization effectively. In particular, the staff should have the necessary qualifications, experience and professional and personal qualities to enable them to carry out their specific duties. In more advanced organization, no hire is performed in the second line of defence is done without the input from the first line of defence knowing that they will be the main customer and beneficiary of the new personnel.  
The professional skills of staff, especially with respect to keeping up-to-date with developments in laws, rules and standards, should be maintained through regular and systematic internal and external education and training.
- ✓ **The model to deployed in all the location where the business operates.** Because these functions are not revenue generating, no short cuts should be allowed no matter how small the business is in some regions or countries. If the business in the region is too small to be able to support the cost of all the infrastructure required for the second line of defence, the function of second line of defence can be taken over by a larger region which has already establish the infrastructure for the second line of defence.
- ✓ **Both lines of defence need to be opened and connected.** The first line of defence needs to be all the time aware in terms of changes of governance, risk management practice as well the second line of defence needs to be aware of the changes in the business and reflect those changes into the internal organization. Hence it is vitally important that the two lines of defence are based in the same location with exceptions that are accepted and properly documented in the governance.
- ✓ **Global consistency of the regional practice and controls.** One of the main purpose of existence of the matrix management is to insure consistency of model of operating both at the regional and global level. That's paramount not only for the second line of defence, but for the first line of defence as well as it insures that one single model deployed globally. These practices are formed in conjunction with the input from

the region, but ultimately the global lead is the one that decide what's the operating model that will be deployed globally. Regional inconsistency can lead for the business to be skewed towards one region with more lax controls or inconsistent risk appetite across the regions. There are many documented examples where the more relaxed controls in one region lead to severe breaches in compliance and risk management, highlighting the importance of globally consistent framework. Again, any exceptions need to be documented and well substantiated whenever they exist.

- ✓ **Senior management of second line of defence** needs to be part of the boards of the directors such that they are able to voice freely their concerns and gap in the frameworks, as well articulate any potential dangerous that can affect the business.
- ✓ **These functions need to identify, document and assess, on a proactive basis, the potential risk associated with the first line of defence activities.** This is especially true in the developments of the new products or business practices or customer relationships. If the company has a new products committee, second line of defence staff should be represented on the committee with the relevant degree of seniority.

### 1.3. Third line of defence

The third line of defence is internal audit with the main mandate to ensure that that the internal governance is operational and the two lines of defence can fulfil their mission (Mülbert, 2009). Regular internal audit is the key to find effective ways to improve the existing process, highlight to senior management gaps in the effectiveness of control or even highlight things that do not operate properly between the first and second line of defence. In the same fashion, as the first line of defence, it is very important that the third line of defence is independent and free from any conflict of interest with a direct reporting line into the board or one of its committee (Hilb., 2011). The auditors should be provided with the freedom to consider any process, procedures and business without any constraint with the acknowledgement and support from the Chief Executive Officers and access to the management information going to the executive committees and the board.

## 2. Pitfalls of the three lines of defence model

Despite being an appealing intellectual construct, in practice it has a series of drawbacks and it is built on a series of assumptions that do not allows work in practice (Hull., 2015). Added to that the intervention of the regulators and external auditors took the independence of the second and third line of defence a little bit

too far, obliging the banks and other financial institution in creating completely different organizations than the first line of defence.

Additional pressure from the regulators with multiple request lead to significant increase in the second line of defence, sometimes beyond the line of affordability and long-term sustainability. Hence a pressure of cost lead to offshoring part of the second line of defence that are purely based on intelligence or violates the principles of being in the same location.

The point above, lead to a significant increase of the cost base of the second line of defence to such an extent that the first line of defence had to drop some of their responsibilities in delivering top standard in terms of second line of defence and expect that the second line of defence is delivering it (Howson, 2009).

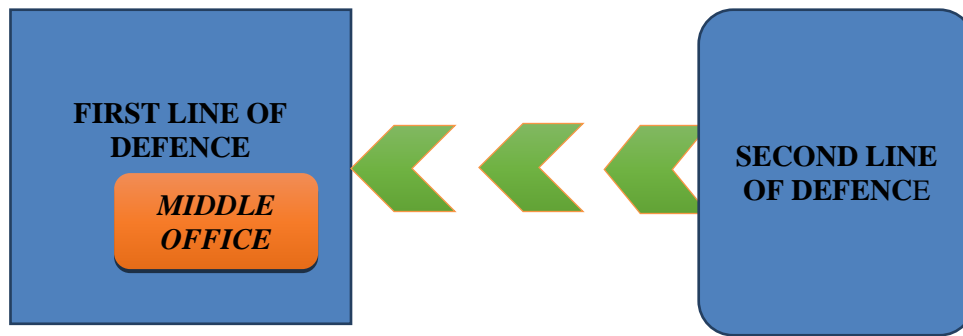
Such a shift in responsibilities and skew in terms obligations lead to many inefficiencies in terms of the set up and deliveries of the second line of defence that maybe a re-shift is needed to avoid the formation of a deeper vicious circles with defects that will be impossible to tackle long term.

For instance, such a shift in division between first and second line of defence leads to the following side effects:

- Second line of defence manifests itself as a first line of defence especially in topics related to cross business management
- First line of defence becomes distant from the tools of the second line of defence as it sees the second line of defence the owner and the sponsor of the tools
- Budgets are allocated strictly between the lines of defence with no synergies between the three lines of defence leading to segregated infrastructures
- First line of defence becomes less sensible and interested in mundane, but equally important topic of static data, leaving the second line of defence as the centre of correction, toll gating and management of static data

### **3. Improvements into the third line of defence structure**

Because of the pitfalls described in the section 2, a slight change in the structure is proposed. This change is related to the creation of a thin layer in the first line of defence which will take over some of the current responsibilities of the second line of defence, as well as develop the tools that are going to be used by the second line of defence in their daily activities.



**Figure 3. Changes proposed in the structure of first/second line of defence**

Such a small change in the organizational structure has important benefits, namely:

1. First line of defence becomes responsible not only for the business and the correct booking and valuation of that, but for the static data that it is related to the business.
2. It develops the tools needed for the second line of defence by taking direct input from one of their downstream consumer, which in this case, is the second line of defence.
3. Becomes the centre of excellence in terms of static data as they are on daily contact with the business the first line of defence is most knowledgeable about the clients, their structure and their organization and can reflect that correctly in the static data of the clients.
4. Creates synergies between second line of defence functions. With the initial structure, any issues related to the static data or booking will be fixed multiple times for each of the function in the second line of defence. In the new improved version of this structure, the data will be fixed upstream for all the functions downstream.
5. Becomes a service provider to the second line of defence while being able to control directly the budget spent on needed development on tools. This structure will be able to create tools that are used across function in the second line of defence functions, breaking up the silos created in the previous set-up on the second line of defence.
6. Second line of defence will become more aware of the issues across organization and collectively they will be able to solve the source of the issue, rather than find short-terms/tactical fixes that serve their benefit only on the short run.
7. The new created sub-function which sits within the first line of defence will have the ability to look across all the asset-classes/functions within

the first line of defence. This was impossible in the previous structure as each sub-business was independent of each other and had no possibility of looking across all the sub-functions.

8. It allows the second line of defence to concentrate on their own “core” responsibilities, knowing that all the issues that were previously polluting their functions are taken care upstream.

The drawback of this organizational structure is that second line of defence is losing slightly its impartiality and independence which can be corrected by the right governance forums where the issues from the second line of defence can be considered (Woods, 2011).

Similarly, by going through such a restructuring the second line of defence can lose control over a significant portion of their budget as well as resources. The side effect of such restructuring is difficult to implement because it breaks the silo mentality which the previous structure.

To be noted as well that such improvements in the organizational structure is only possible if the first line of defence can attract the special matter experts from the second line of defence, such that becomes a credible and completely functional division. This is required as the function needs to have a deep understanding of the way the second line of defence function, design tools, create static data that it is reliable and become an excellence centre for fixing all the issues that should anyway sits with the first line of defence.

#### 4. Conclusions

The current implementation of three lines of defence has been under intense scrutiny, especially after the financial crisis, however changes in these structures can make this set-up something workable on the long run. However it requires redrawing the lines between the different lines of defence and reinforcing the roles and responsibilities of each of the line of defence.

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