Three Lines of Defense in Effective Risk Management

Presented by:

Carolina Reames
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Questions

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Today’s Presenters

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Three Lines of Defense in Effective Risk Management
Agenda

• Overview
• The First Line of Defense
• The Second Line of Defense
• The Third Line of Defense
• The Three Lines of Defense (Large/Small Companies)
• Current State of the Model
• Questions
Overview of the Three Lines of Defense Model
History of the Model

Where Does the 3LOD Model Come from?

What are the Three Lines of Defense?

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Three Lines of Defense Model

From ECIIA/FERMA Guidance on the 8th EU Company Law Directive, article 41
The First Line of Defense
First Line of Defense

- The first line of defense is the business unit, specifically functions that own and manage risk.
- Operational Managers:
  - Own and manage risk, and
  - Understand the risk to the business.
- Controls are designed into systems and processes under the guidance of operational management.
Operational managers implement internal policies and procedures to mitigate risk. This could include identifying controls are in place that address both preventative and detective risk:

- **Preventative Risk** (for example, not allowing access to be granted to certain areas)
- **Detective Risk** (for example, periodically reviewing transactions and access to ensure they align with established goals and objectives.)
First Line of Defense, Continued

- Mid-level managers design and implement procedures (controls) and then supervise how their employees execute them in the course of business.
- Sufficient managerial and supervisory controls should be in place for compliance, to identify control breakdowns, and to handle unexpected events.
The Second Line of Defense
Independent Oversight of the First Line of Defense

Risk Management & Compliance Functions Include:

• Supporting Management Policies and Procedures, defining roles and responsibilities and setting goals for implementation.
• Providing risk management frameworks
• Identifying Risk in the organizations risk’s appetite by analyzing known and emerging issues.
• Assisting management in developing processes and controls to manage risk and issues
The Third Line of Defense
The third line of defense is assurance providers (Internal Audit)

This high level of independence is not available in the first or second lines of defense.

These assurance groups report independently to the board or audit committee.
Third Line of Defense, Continued

• Internal Audit’s key role in the organization is to:
  • Identify risks;
  • Validate that risks are managed by appropriate controls; and
  • Test the effectiveness of the controls.
• Internal Audit pulls together all three levels of the model by providing assurance to senior management and risk owners.
Internal Audit: The Cornerstone

• Internal Audit has a unique position within the organization to provide assurance.
• Internal Audit can be utilized to fill an advisory role in some organizations.
• Internal Audit can be combined with the first and second lines of defense:
  • Managing a workplace whistleblowing arrangement
Internal Audit’s Use of the 3 LoD Model

1. Internal kick-off meetings;
2. When recommending internal control changes;
3. Summarizing control issues by themes;
4. Providing control training;
5. Obtaining approval for governance, risk, and compliance projects; and
6. Suggesting change to internal audit responsibilities.
How Internal Audit Continues to Adapt

- Internal Audit must focus on financial and non-financial regulations
- Compliance with evolving industry regulations
- New responsibilities given to Internal Audit by governing bodies.
The Three Lines of Defense (Large/Small Companies)
Large vs. Small Companies and the 3LOD Model

Is the Three Lines of Defense Model useful for any organization regarding of the size?
Large vs. Small Companies and the 3LOD Model, Cont.
Current State of the Model
Renewed Focus on Risk Management

• The Great Recession and its aftermath caused companies to refocus on the effectiveness of risk management.

• Banks faced:
  • More than $235 billion in fines from the government and regulators
  • Regulatory changes

• Could a different model have prevented or reduced the impact of the Financial Crisis?
3 LOD Implementation Challenges

A recent survey of financial services professionals found several implementation challenges:

1. Lack of agreement on roles and responsibilities across and within lines of defense;
2. Difficulties evidencing individual accountability, including decision-making;
3. Inefficient manual controls subject to human error; and
4. Inconsistent approach and variability in protecting supervisory confidential information.
• The practitioners’ issues with the model show the connection between the three lines of defense:
  • If an organization can’t agree on roles and responsibilities, how are employees or others held accountable?
  • Manual controls increase the risk of leaking data or other confidential information.

• New tools
• Changing regulations
Are 3 LoD Model Updates Needed?

Source: Intralinks and Risk.net
The Need for Accountability in Each Line

• A lack of understanding and agreement of the roles and responsibilities is seen as having the greatest impact on the model’s effectiveness.
• The structure of the three lines varies between business and industries.
• The vagueness of the model offers flexibility but also uncertainty. This can lead to:
  • A breakdown of controls
  • Misaligned incentives
The Need for Accountability in Each Line, Continued

Regulators have been increasing transparency in individual accountability:
  • For example, the Yates Memo requires firms to disclose individuals involved in wrongdoing to receive cooperation credit in corporate misconduct cases.

Individual accountability should encourage the 3 LOD model by encouraging the implementation of stronger controls.
Barriers to Internal Audit’s Relationship with the 3 LOD Model

• Barriers that often limit Internal Audit’s effective relationship with the 3LOD model:
  • Concern that placing reliance on others will impair independence & objectivity.
  • Lack of maturity by the 1st & 2nd LOD
  • Lack of guidance for evaluating the lines of defense
  • Ineffective reporting alignment of Internal Audit
Fourth Line of Defense Model

• The Financial Stability Institute suggests updating the 3 LoD model to include a fourth line.
• The fourth line would comprise external parties such as external auditors and regulatory supervisors that would assist in the design of the organization’s internal control system.
• The model would rely on the flow of information across all the lines of defense.
Final Thoughts

- Organizations will continue to seek more efficient and effective ways to manage risk and ensure sustainable success.
- An approach must be identified that provides employees with clear roles and responsibilities.
- The 3 LoD model provides a foundation of risk management but will need to adapt over time.
QUESTIONS?

Thank you for your time!

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