The three lines of defence model of tomorrow

Since the financial crisis, many reviews have been executed to assess how financial institutions managed risks at that time. Most reviews revealed weak governance and lack of a robust risk and control environment. Financial institutions failed to demonstrate that those accountable for bringing in the risks (and returns) understood the importance of the unmitigated exposure their institutions were facing. In addition, those in charge of overseeing such behaviours were equally unaware and ill-equipped.

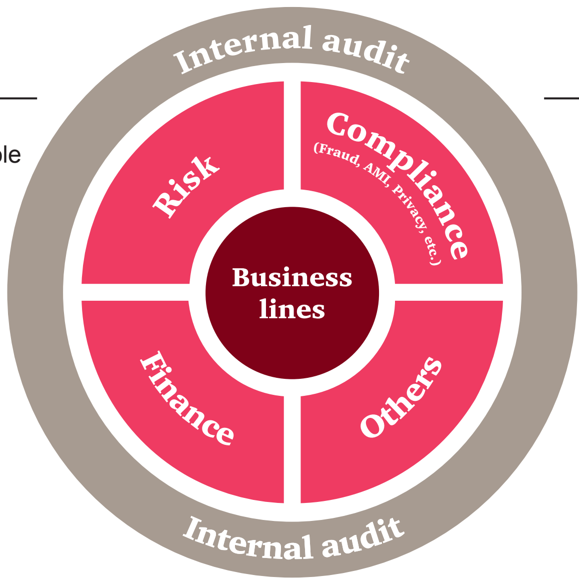
In response, global regulators issued guidance in an attempt to challenge various aspects of the design and application of the traditional three lines of defence operating model. As a foundation, regulators are encouraging financial institutions to establish a risk management culture that demonstrates a 'walk-the-talk' behaviour—from top to bottom.

Figure 1: ***The traditional three lines of defence model***

What needs to change

1st line of defence

- Lack of accountability
- Unclear understanding of new role
- Wrong tone from the top



2st line of defence

- Absence of coordination
- Siloed operations
- Dealing with first line's functions
- Limited use of data and technology

3rd line of defence

- Outdated data management and analytics

While financial institutions have made good progress in building an effective three lines of defence model to respond to regulatory expectations, the model still isn't fully embedded and hasn't been consistently applied within organizations, leading to duplication of processes and lack of understanding of roles and responsibilities across the organization. This lack of clarity is part of the reason why the first line (business line) isn't taking complete accountability for risk and the second line continues to operate in silos.

The case to upgrade the model to adequately include effective risk management has never been stronger. A refreshed model needs to focus on ensuring greater accountability of risk by the first line while building better coordination within the second line, implementing new technologies to increase effectiveness and reduce costs,and revising talent management strategies to get the right people in the right roles

An integrated and coordinated framework

The weakest link in the implementation of this model is the understanding of roles and responsibilities. As a result, the first line ends up neglecting its accountability and ownership of risks, forcing the second line to compensate to make sure the control environment remains strong. Business line (first line of defence), in many cases, still expects the second line to identify and present them with a report that outlines the risks in their business, rather than take full responsibility for those risks. With the current model, the second line isn't able to focus on its core responsibilities: reviewing and challenging the first line's risk assessments, providing insights on underlying risks and keeping ahead of trends and emerging risks.

Financial institutions should realign responsibilities across lines of defence, making sure the first line is more engaged and consider all strategic implications when driving risk identification, assessment, measurement, management and reporting processes. Making sure the tone from the top, enterprise and business risk appetite, performance management and compensation philosophy are in sync with company strategies is crucial to this transformation.

Today the scope of regulatory compliance is broader and its impact on business far greater than ever before. New regulation due to the financial crisis has posed a significant cost to financial institutions. At most banks, second line of defence responsibilities are spread throughout the organization and have developed independently over time, leading to varying processes for risk assessment, testing and reporting. For example, some areas—notably compliance with the 'alphabet' regulations such as Regulations CC and Z—are very mature, but haven't taken advantage of newer analytics capabilities in other areas such as Fraud, Anti-Money Laundering (AML) and Compliance to pre-emptively identify higher-risk areas. Financial institutions need to enhance coordination of their second line functions to avoid facing high costs and losses in the form of escalating litigation, penalties, as well as staffing needs due to duplication and inefficiencies.

Merging functions may not be possible in some cases, but leading organizations have already started to identify operational efficiencies by studying second line activities and integrating them where it makes sense. Compliance and operational risk functions are already making the most of key risk indicators, key performance indicators and, where possible, risk and control assessments to provide reporting to senior management.

To enable a more coordinated and efficient approach, companies must change existing risk assessment programs, using a common scope, language and taxonomy, while eliminating duplicate inputs. Revising existing assessment tools and programs will help the team cover multiple internal and external requirements and add significant business value.

A defence model driven by technology

Technology and innovation are reshaping financial services from the outside in. Mobile devices, innovative payment systems, analytics and technologies like blockchain are forcing changes in all industries, including financial services. Technology plays an 'enabler' role in the transformation of the three lines of defence model.

As disruptors and fintech companies continue to be the trending topic and become the standard in the industry—thanks to their easier, cheaper and faster processes—financial institutions should join in, embrace disruption and aim at making their operations faster, adding more value to the business and providing simpler solutions to their customers. Technology has delivered new capabilities to distribute services and reduce the traditional costs of doing business.

Adopting new technologies is also key to upgrading the model, since it will empower organizations and allow them to manage data from all sources more effectively (for example, business line, unstructured data and risk assessment data from various second line functions), increase efficiency of core second line processes and use data tools to perform advanced analytics. In addition, technological enhancement can help most financial institutions that face the issue of multiple sources of the same data—leading to a proliferation of data warehouses, lack of a single source of truth and a limited ability for data aggregation and analytics.

When establishing a highly effective three lines of defence model, financial institutions need to take advantage of technology to manage all the data available. The excessive amount of data, along with new methods to capture it and the declining cost of doing so, will reshape the risk and control landscape. The emergence of the Chief Data Officer (CDO) as a new management role is a testament to the importance of data in leading organizations. We've helped CDOs at financial institutions to bring a "treat data as a strategic asset" perspective and potentially act as a second line that plays a more coordinated governance, oversight and challenge role.1

As organizations begin to manage data effectively, they'll be able to use the faster computer power and data storage capabilities available to enable advanced analytics, developing better risk management techniques and risk decision support. Risk and compliance functions in many companies have started venturing into big data analytics supported by technology to strengthen their assessment programs. For example, some organizations have started mining data gathered during their know-your-customer process to identify insights into customer travel patterns and foreign transactions, adding business value by using this information to market their products?

Financial institutions should use the opportunities technology offers today to empower the second line function and further enable a successful new framework.

1 PwC. February 2015. Great expectations: The evolution of the chief data officer. http://www.pwc.com/us/en/financial-services/publications/viewpoints/chief-data-officer.html. Retrieved May 30, 2016.

2 PwC. April 2015. The extra mile: Risk, regulatory, and compliance data drive business value. http://www.pwc.com/us/en/financial-services/publications/viewpoints/risk-regulatory-compliance-data.html. Retrieved May 30, 2016.

Right talent for long-term success

Finally, a successful model requires a drastic change in how financial institutions approach their talent management strategy. People are fundamental to driving change, and the traditional model can't be upgraded if you don't have people open to and capable of doing it. It's important for organizations to understand their talent needs and develop training, succession and planning accordingly.

To support this process, Human Resource (HR) functions should focus on developing the right talent. The second line needs to have depth of capabilities like data management, advanced analytics and advanced mathematical and statistical training. But the first line needs to boost its capabilities with resources able to address risk and compliance, keeping a customer-centric focus.

In addition, given the struggle organizations globally are facing in finding and retaining the right talent, all organizations should embed and integrate workforce planning into business planning from the start, rather than treating talent as an afterthought. This demands strong support from the Board on talent sourcing and management and close ongoing collaboration between the HR function and the key stakeholders from all three lines of defence.

An upgraded three lines of defence model can significantly enhance the risk and control environment in an organization. Financial institutions should assess their current capabilities and develop a tailored strategy that builds on early wins as well as long-term organizational change. The strategy should include the following:

- broad executive-level ownership and visible support for change, including committed leaders representing a cross-section of the organization
- a shared vision for stakeholders that includes organizational change, talent sourcing, as well as management strategy and agreement on a new, coordinated second line (a risk-based view)
- willingness to invest in technology and an open-minded approach to adopting change
- an actionable plan that demonstrates a clear understanding of gaps, outlines a road map to the future state and is supported by a sound business case

For financial institutions to be successful tomorrow, it's essential to build strong foundations to operate this new model that adapts to growing challenges today. Not only are the upgrades meant to address internal and external stakeholder expectations—they're also meant to enable organizations to identify cost-saving synergies and enhance business value.

Contacts

Jan Driessen
Internal Audit Services
Partner
088 792 5587
jan.driessen@nl.pwc.com

Frank van Dissel
Internal Audit Services
Senior Manager
088 792 6800
frank.van.dissel@nl.pwc.com

Irene op den Buijs-Magielsen
Internal Audit Services
Senior Manager
088 792 3432
irene.op.den.buijs-magielsen@nl.pwc.com