

Managing the Three Lines of Defense



In 2012 Carlo di Florio, the then Director of the SEC's Office of Compliance Inspections and Examinations, had stressed board members, senior management and parent companies play an important role in setting the 'tone at the top.' One way they can do this is by ensuring that there are three effective lines of defense: front office management, the risk management function and internal audit. This represents international best practice and requires a robust internal control system. The three lines of defense model helps to clarify the role and responsibilities of individuals across the bank and ensures risks are controlled.

BOARD RISK EXPERTISE

The board of directors are to receive reports, directly or indirectly, from each line of defense. It is important that they have access to this information so that they can provide a credible challenge to risk-taking behavior. However, board members may lack the sufficient expertise or time to understand complex risk management issues. This is something the US Department of the Treasury (USDT) has recognized in their 2017 paper entitled, 'A Financial System that Creates Economic Opportunities.' The USDT recommended that the burden placed on boards should be reviewed.



88 %

% of US and European global systemically important banks (G-SIBs) that have at least one member with risk experience on the board in 2017. A director is considered to have risk experience if he/she has held a senior executive risk/internal audit position within a financial institution.



43 %

THE ROLE OF THE BOARD COMMITTEE

The first line of defense (LoD) is made up of individuals who manage risks on a day-to-day basis. They are well placed to act when a gap is identified in the risk governance framework. The role of the second line of defense is to ensure risks are properly documented and risk escalation procedures followed. This involves individuals engaged in compliance and board committees. The risk and audit committees are central to the risk management function and should challenge the status quo. To deter wrongdoing and perform internal control they need the power to intervene. To do this they first need oversight responsibility.



% of US G-SIBs where the Audit Committee oversees internal controls

ROLE OF INTERNAL AUDIT

The third line of defense is the internal audit function. They are to be operationally independent from management, so they can attest to the quality of the bank's risk management and internal control processes. The Basel Committee on Banking Supervision highlight three main features of an internal audit function: independence and objectivity, professional competence and integrity. However, some critics argue this 'line' should be extended to include external parties.

% of US G-SIBs who disclose the board approves the remuneration of the head of internal audit



% of US G-SIBs who disclose external auditors attend all meetings of the board's audit committee*



*US & European G-SIBs, data valid as of 31st. December 2017

THE REGULATOR'S VIEW:

"The internal audit function should develop an independent and informed view of the risks faced by the bank based on their access to all bank records and data, their enquiries, and their professional competence.."

Basel Committee on Banking Supervision, The Internal Audit Function in Banks, 2012.

CHANGES TO THE 3 LINES OF DEFENSE MODEL

For the 3 lines of defense model to achieve the desired outcomes there needs to be a cultural change within the bank. Each line of defense should coordinate their efforts whilst maintaining their structural independence. The Bank for International Settlements has argued that the inclusion of external parties, such as the supervisor and external auditor, could enhance the 3 LoD model. The bank in this instance would be encouraged to engage in trilateral talks between the supervisor and external auditor. It is also suggested that the use of new technologies could improve the 3 LoD model. Where technology can be used to improve communication then a more accurate picture of the enterprises' overall risk management processes can be made.

ABOUT AKTIS

Aktis is the first and only bank governance data platform. The Aktis data universe provides accurate and trustworthy insight to levels previously unavailable for bank governance data.

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