

The three lines of offense

When uncertainty is the only certainty, is it time for companies to view risk management as a competitive advantage?

The EY logo, consisting of the letters 'EY' in a bold, white, sans-serif font, with a yellow triangle pointing upwards to the right of the 'Y'.

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Effective risk management is often framed around keeping a company out of trouble. But faced with technological disruption, customer empowerment and low/no barriers to entry, a company can no longer survive simply by defending itself. By rethinking how it deploys the three lines of defense model, an organization can make its risk management process a force for more nimble decision-making and innovation.

If we turn the clock back 42 years to 1975, 83% of the value of a company was driven by its balance sheet. Compare this with today, where estimates suggest that only 20% of a company's value sits on its balance sheet, and we can glean one thing: the issues inherent in an increasingly fast-moving world – such as reputation and the need for constant innovation – have had an increasingly big impact on share price.

Having a healthy balance sheet and the best product in the world is only half of the story. Today, a company's reputation is crucial in maintaining its customers' trust and loyalty. Yet reputation can be irrevocably damaged in a matter of months, days – or even hours – and depends on much more than preventing downside risks. A company has to go way beyond keeping up to build and maintain its customers' trust. It must be able to demonstrate innovation and take considered risks and deliver a superior return.

However, innovation without agility will mean that organizations are forever playing catch-up – such is the pace of change in today's information age. Agility is a prerequisite not only to survival, but to the future success of any organization – as it must be capable of quickly assessing strategic risks and taking decisive action.

The danger has always been that managing risk is viewed as a hindrance to entrepreneurial spirit, when in fact

it should be the facilitator of today's agile business. However, only by understanding its own approach to maximizing upside risk and managing downside risk can an organization be more entrepreneurial and make sound decisions about new growth opportunities – or step away when the risk/return profile appears unfavorable. Yet being nimble doesn't simply require a more efficient way to filter risk – it calls for a different approach to it altogether.

Too many companies fall into the trap of seeing risk management as a hindrance to an entrepreneurial spirit.

Agility depends upon efficient internal risk processes that offer a company the flexibility to put its pedal to the metal when the moment is ripe. This calls for clarity in roles and responsibilities for risk management. It also calls for scalability, a flexible risk process that can cope as an organization grows. So, the short answer to the title question is yes – now more than ever, for enhancing risk management processes can make an organization more innovative, agile and competitive. And we believe that the three lines of defense model continues to offer the best framework from which to reimagine risk management.



How the three lines of defense model facilitates agility

It is true that the three lines of defense model has come under a lot of scrutiny of late. But this scrutiny is good – because in our view it's not so much the model itself that poses an issue, but how an organization executes it.

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The model is the preferred approach of regulators. This includes the Financial Conduct Authority and the Prudential Regulatory Authority in UK, as well as the Office of the Comptroller of the Currency in the US. Executed well, a solid strategy built around the three lines of defense framework enables a firm to demonstrate to its regulator that risk accountability works. It can also facilitate cultural transformation, as senior executives become increasingly accountable for any control failures. But aside from appeasing the regulators, the three lines of defense model can actually help an organization grow, strengthen and win – by building a match-fit and offensive team. We will be looking closer at some examples of exactly how in a moment.



None of this is to say the model is perfect. It is not. Responsibilities – and as such, accountability – across the three lines have been unclear for many companies. There is a big question about the extent of integration across some of the lines, resulting in unnecessary duplication of effort, and therefore cost.

But it is one of the most recognized models there is. And an internal review of how an organization uses the model can unveil much broader opportunities for growth and innovation. A good place to start is not thinking of the three lines of defense framework as a one-size-fits-all model. Knowing how to navigate some of the framework's issues, and reorganize to suit an organization's specific situation, will open up new opportunity – opportunity that will not only make a business more efficient, but will help it become more nimble thanks to:

- ▶ confident decision-making
- ▶ scalability of risk management processes
- ▶ cost reductions

Sound familiar?

- The understanding of where responsibilities for risk management lie within the company is a bit murky.
- Risk does not always feature effectively in strategic decision-making.
- There is not always a clear understanding of the company's risk appetite – as such, action is often passed from one line to the next line up.
- Assurance costs in the third line of defense are higher than they need to be.
- There is a lot of duplication of effort across your company's three lines of defense.

Case studies

Using live examples, let's look at each line of defense to demonstrate how addressing some of the issues can facilitate a more agile and entrepreneurial approach – and put an organization back on the offensive.



1st line of defense Seeing risk from a different angle



By thinking of risk in terms of its nature, its upside and downside potential, and the ability to influence it, coupled with a clear and shared understanding of its risk appetite, a company is forced to deal with it differently. It is likely to mean breaking risk down into key areas, which will not only remove some of the ambiguity (which can undermine accountability) but will create immediate opportunities to tighten up the entire risk management process.

There is a clear difference between those more manageable risks relating to, say, compliance or business continuity (which can be prevented) and the risks associated with innovative growth, for example. Preventable risks are likely to be managed quantitatively, with zero tolerance to failure. Growth risks, however, will call for an objective evaluation of each individual opportunity – and a clear understanding of the risk/reward equation.

Below is an example of how one company looked at its Principal Risks through a different lens. It led to a clearer, more simplified process and made risk a more prominent part of the decision-making process.

What was the issue?

Company A had repositioned its market strategy and transformed its operating model. This exposed it to a different set of risks and opportunities and it was keen to ensure that its risk management capabilities and Lines of Defense model was fit-for-purpose. After evaluating the maturity of its risk management function, Company A identified four key issues:

1. There was a lack of clear responsibility and accountability when managing risks.
2. Risk appetite was not well articulated, or even understood across the business.
3. The assessment of risk tolerance played a very limited role in the actual decision-making process.
4. Rather than individuals taking responsibility for risks, most of the accountability had been pushed across to the risk function.

From these findings, it became clear that the people in charge of the first line of defense were confused about their own role. They were also unclear about the extent to which risk played a role in making day-to-day decisions, and which risks needed what mitigating action.

What was done to address it?

In response, Company A realigned its Principal Risks to three simple categories:

1. Strategic risks – upside risk opportunity requiring an evaluation of the risk-reward balance.
2. Preventable risks – downside risk which need to be mitigated, avoided or eliminated.
3. External risks – those beyond the control of the organization.

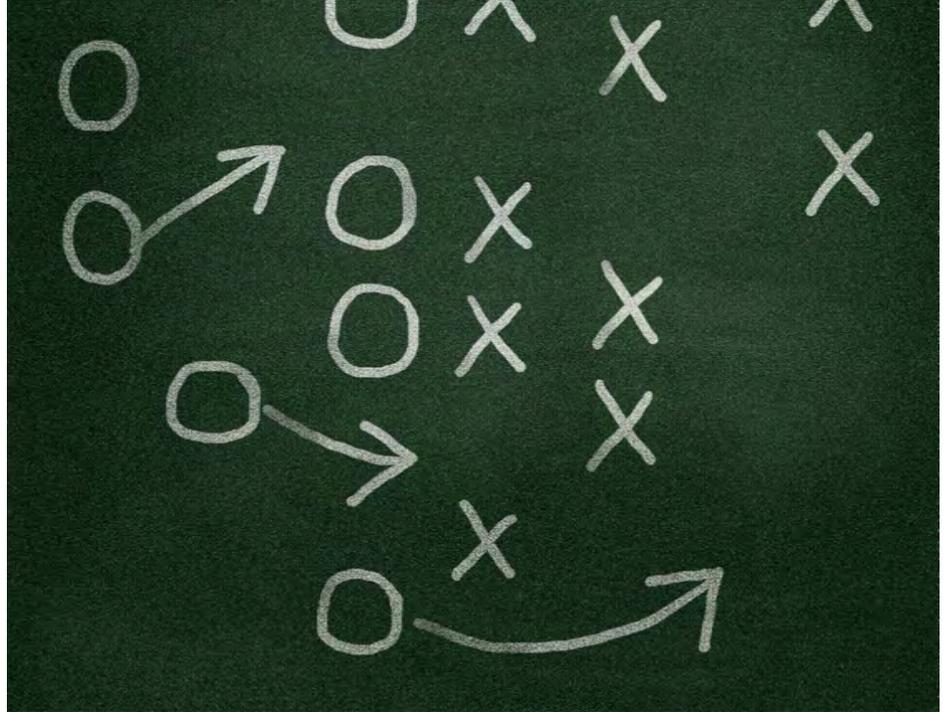
By doing this, the organization was able to better define the responsibility and accountability for the management of specific risks as well as its appetite for upside and downside risks. It put itself in the position of being able to clearly articulate how the scale and proportion of risk management activity – and decision-making capacity – would differ depending on the categorization of each risk.

What was the outcome?

Company A created a more efficient risk management process, including a better understanding of its risk appetite, which enabled it to make agile, yet more risk-informed decisions.

2nd line of defense **Scalable and cost-effective monitoring process**

Cost is a significant factor in any company's ability to be agile. More resource to reallocate to innovation means quicker response times and better decision-making. So, rethinking monitoring processes – addressing legacy systems and thinking about ways to simplify and automate functions – can help trim some of the burden that can hold a business back. Here's an example of how one business did just that.



What was the issue?

Company B identified that its finance controlling and compliance costs were twice those of some of its more efficient peers. Furthermore, inefficiencies in their finance function meant that it took as much as five times longer than some of these more efficient companies to close its books at the end of each month.

The significant investments that had been made in enabling technologies had not been fruitful thus far, largely because the functionality of the technology had not been well understood by individual users within the business. There was an opportunity to automate and simplify the controls environment – which meant control activities as well as control monitoring.

What was done to address it?

First, Company B established a global *Controls Centre of Excellence*, which was responsible for designing and mandating a common set of controls across the organization. The design principle (driven by the Controls Centre of Excellence) was the drive towards significantly higher levels of automated and preventative controls, and the decommissioning of duplicate, manual and ineffective legacy controls. Its starting point was to apply zero-based logic to its internal control framework, thereby driving the reduction in the number of financial controls in line with its risk appetite.

The next phase focused on the second line of defense. By establishing dashboards, continuous control monitoring was enabled, built on the mining and analysis of finance data. An offshore *Controls Service Centre* was also set up to deliver the continuous control monitoring service.

What was the outcome?

The costs of both finance controlling and compliance activities were reduced. This was coupled with a scalable second line of defense, where costs could be contained irrespective of the growth ambitions of the organization. The savings could then be redirected towards growth and innovation activities.

3rd line of defense **Aligning the second and third lines to reduce assurance costs**



Like a domino effect, redefining and reorganizing risks and functions in the previous lines of defense is likely to lead to opportunity to reassess the assurance process: aligning the second and third line can lead to significantly reduced assurance costs, for instance. In this example, the same company from the previous page reduced its audit costs as a result of sharpening its control and monitoring functions at the second line.

What was the issue?

In our previous example, Company B wanted to align its Lines of Defense model to its risk appetite, thereby reducing the cost of its financial controlling and compliance activities. At the same time it saw an opportunity to reduce its expenditure on audit – both internally and through its use of external auditors – by addressing the total cost of assurance at the third line of defense.

What was done to address it?

Finance controls were rationalized and automated. The company determined which controls would be continuously monitored by the *Controls Service Centre*. Subsequently, the role of the Internal Audit function, in relation to assurance over finance controls, was redefined: Internal Audit would only provide assurance over residual manual key controls, and assurance for all other key financial controls relied on the continuous monitoring from the *Controls Service Centre*.

It was also agreed that Internal Audit would periodically review the work of the *Controls Service Centre*. The objective was to assess the robustness of algorithms and systems configuration to assure the integrity, reliability and accuracy of the data being mined and analyzed by the second line of defense. This latter change in the assurance work performed by Internal Audit also called for the upskilling of team members, as well as changes to the internal audit methodology.

What was the outcome?

By aligning the work of the second and third lines of defense – and redefining the finance assurance needs of the organization – the company anticipates a significant reduction in the total cost of assurance over the next three years.

Making risk part of the offensive

What we have seen is that the three lines of defense offers an effective model to build in greater efficiencies and enable agility. To employ it effectively, a company must view risk under a different light. Continuing along the same lines may well prevent breaches that will have a short-term impact on reputation, but it is unlikely to enable the nimble decision-making, cost efficiencies and scalability required of today's innovative enterprise.

With a computer, there comes a point when it is no longer worth upgrading the software to keep it up to date: it becomes an impediment to efficiency, and it is better to scrap it and upgrade the whole machine. The application of a three lines of defense model is no different: instead of continuing to bolt on quick fixes, it requires a different approach, with some creative rethinking.

Getting all three lines of defense working effectively means addressing them one by one, and then getting them working together. We have seen in the examples above how more efficient monitoring in the second line of defense led to reduced assurance costs in the third, for example. Being creative, and addressing the root causes of some of the issues of the three lines of defense model, can deliver a risk management strategy that helps a company be proactive and able to manage higher levels of innovation and disruption. With the three lines of defense, the framework is there. It is down to each organization to reimagine it, and get risk back on the side of opportunity.

A strong three lines of defense process should:

- ✓ Apply a different lens to your risks, considering categories such as strategic, preventable and external
- ✓ Remove ambiguity from your three lines of defense approach by clarifying roles, responsibilities and accountabilities
- ✓ Make risk appetite an inherent part of strategic decision-making
- ✓ Set expectations across the company around how risks are controlled, monitored and assured, and provide timely reports to management and the board
- ✓ Create a risk ownership culture by placing process owners at the heart of risk management efforts
- ✓ Reduce costs through greater control and monitoring automation, better leveraging existing technology solutions and eliminating duplication across the three lines

How EY can help

We can help you extract opportunity from uncertainty by aligning and improving your lines of defense to the nature of the risks you face, and your appetite for those risks.



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