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Three lines of defence: Risk management supporting strategic goals

Erik Haggstrom

This is my passionate belief and one that today's discussion will be exploring in the context of what I believe to be one of the key pillars to support successful risk management – the 3 lines of defence risk management model.

In relation to the statement, too often Board's and business management fail to understand that a good strategy will not naturally lead to success.

There will be blockers and barriers along the way. And any business that doesn't have good risk management to deal with this I believe is destined not to achieve.

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- Australia, US and UK
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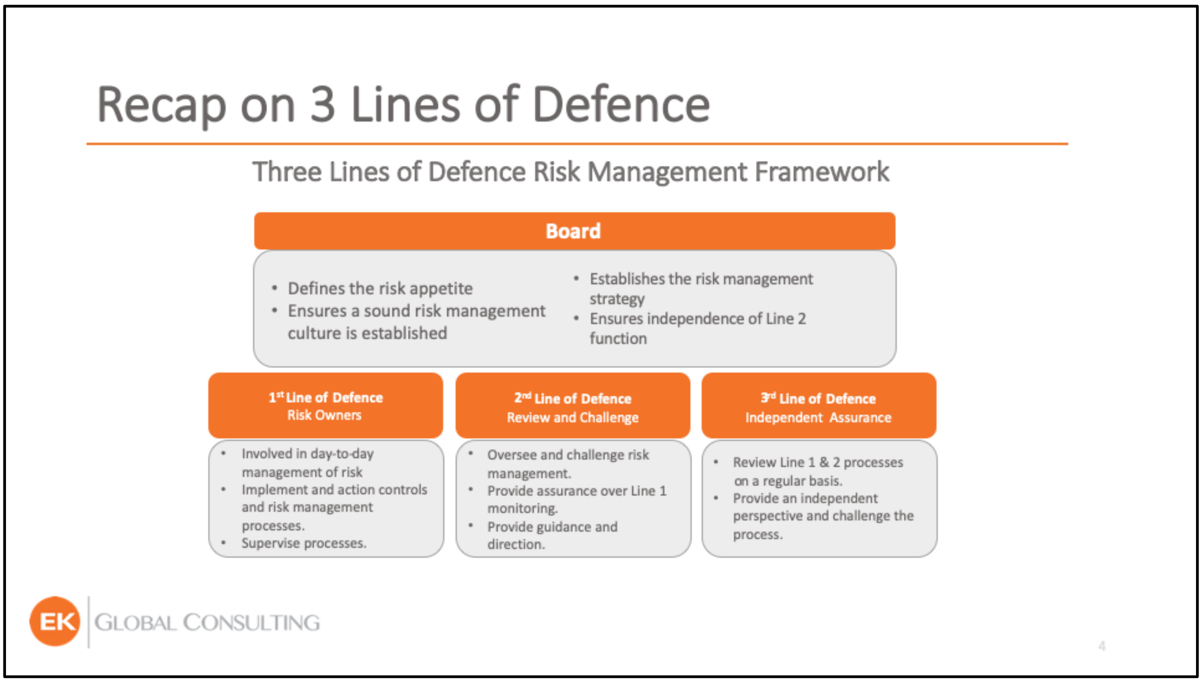
I have spent about 25 years working in financial services and consulting:

I came to risk through a roundabout journey because the more I worked with business the more it became obvious to me that businesses need good process to support success.

Throughout my career I have focused on the build and implementation of risk management frameworks and processes across financial services business predominantly financial advice, funds management and investment banking.



So why is the 3 lines so important? Why is it so good?

Because it naturally builds alignment with the goals of the business. And with that alignment a greater likelihood that of strategic goals success.

The Board sets the strategic goals and then defines the risk appetite linked to those strategic goals – we heard a great discussion on this so I won't elaborate much on this – and that risk appetite frames the activities of Line 1, Line 2 and Line 3.

Line 1 – Management, the business own the risk. The manage the risk on a day to day basis. They implement those controls required to manage to the risk appetite and they make sure they supervise to this. At its simplest if this is done well the risk is managed to the risk appetite increasing the likelihood of success.

Line 2 – Review and Challenge, usually a risk management function or some version of. They will perform oversight of the supervision (but not actually perform the controls). They will provide assurance to the board that the Line 1 is or is not managing the risk within the appetite.

Line 3 – Independent Assurance – taking it a step further to review the performance of line 1 and line 2.

In principle a simple and effective model with levels of activity and review that will support the goals of the business. Yet it seems there is constant resistance and lack of understanding across many businesses.

As part of today's discussion I want to walk through some of the challenges in successfully implementing 3 lines of defence risk management

Science

Science

- Frameworks
- Models
- Data

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I think that getting the approach right is critical to successful implementation of the 3 lines.

Risk management is about process and we are all keen I think to dive into that science.

Frameworks: Frameworks are key to provide a starting structure, a form of standardisation that helps people internally and externally to understand and assess whether the organisation is well set up and likely to succeed in managing its risk.

Models: We will all build models to help our risk management implementations. Whether they are models to calculate or quantify risk or whether they are more practical operating models that help ensure consistent execution they will usually add to the likelihood that risk management efforts are successful. They help with efficiency and decision making.

Data: Data is crucial. Data is a key building block in helping our decision making. The modern organisation is building vast amounts of data. AI, machine based learning, those buzz words they will continue to improve our decision making based on data.

You know that the science is strong but we need to be nuanced when implementing. Because the organisations that we operate in and the strategic goals that they are trying to achieve are still much more complex than any scientific solution.

But Risk management is more than science.

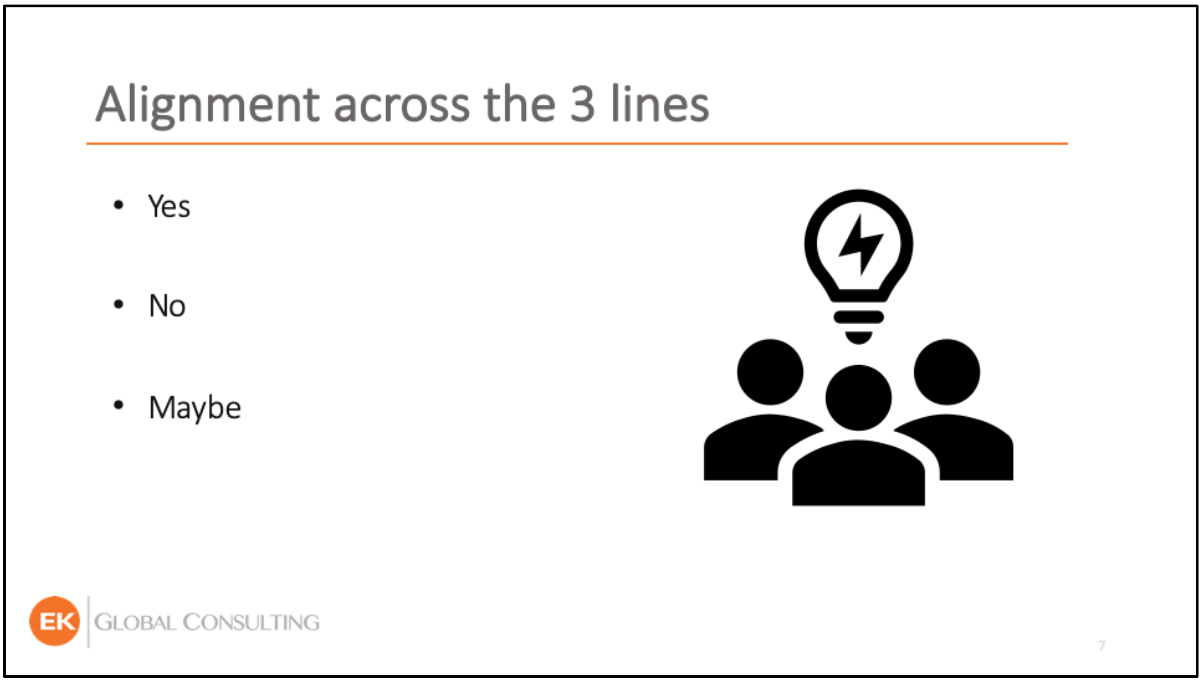
We need to embrace the art if we want to successfully implement our three lines. And it is critical to keep this in mind as we think how risk management and the 3 lines of defence can support the achievement of strategic goals in a pragmatic and fit for purpose manner.

Flexibility: We need to be flexible in the way that we use the science of risk management. Governance standards, Board make up, Management skills, Risk and Compliance resources, Independent assurance. These will all vary across organisations and we need to be aware of this. Our 3 lines of defence will not work if we aren't able introduce some flexibility. For most organisations risk management is a continuous journey. We can't expect an organisation to move in a linear and efficient manner to a fully fledged 3 lines of defence implementation. We need to maintain our flexibility when we talk to the board, to management, to risk and compliance and to our independent assurers. We find that we need to spend a lot of time communicating with boards and senior management to identify the correct level of flexibility. And a lot of these conversations are really about building an iterative process.

Creativity: We all need to explore our creativity in implementation. We must be open to ideas and willing to work creatively to create solutions that will work for the organisation. Anyone looking to implement or improve the 3 lines of defence must be able to imagine structures and process that will take the organisation the implementation journey. We have had situations with clients where we have had to improvise with a Line 2, identifying part time internal resources that we can use to start the process and then with maturity expand to a full time resource.

Passion: Bring your passion. Too often people apologise for risk management. I can't stress enough how critical risk management is to business success. How the successful implementation of 3 lines will drive success because it is aligned to managing the success of goals.

For me this passion is key to success. Do you think you are going to get a boards engagement without that passion. They want to see that you care. Because if you don't then how can they.



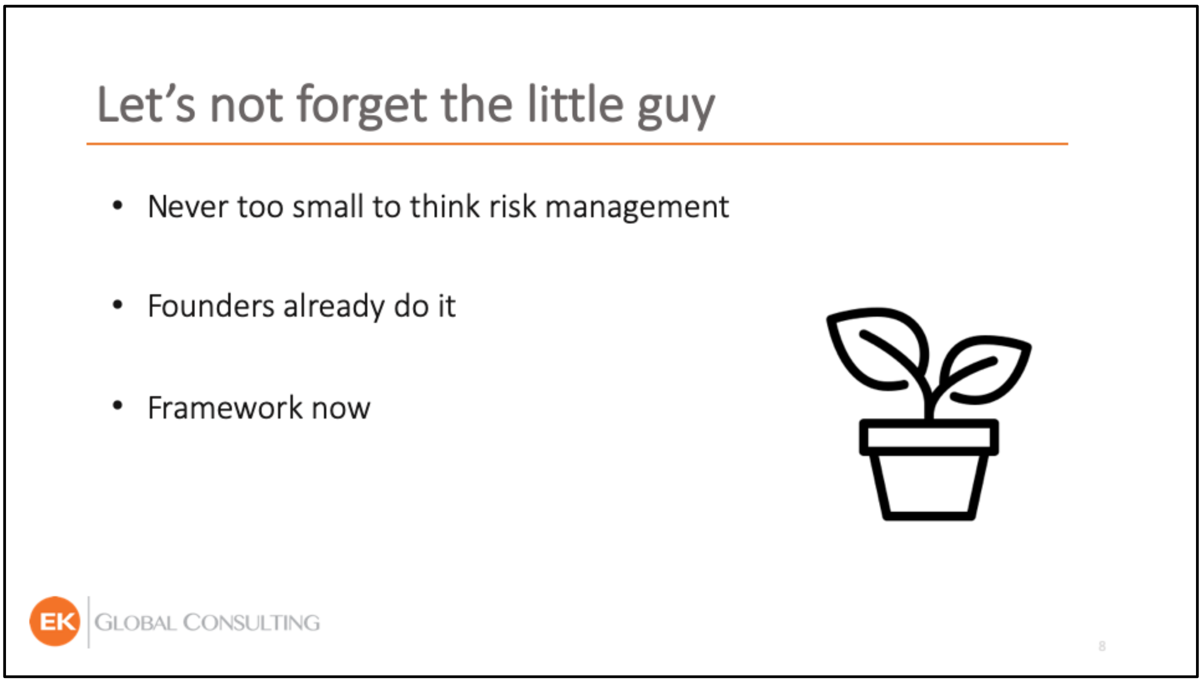
Alignment is a tricky discussion. My view on alignment is as the slide suggests. Yes, No, Maybe. What I mean by that is each line needs to be aligned in supporting the strategic goals. But they each area has their own goals which don't necessarily align. But they do need to work together so there needs to be understanding. 3 areas I would highlight in this discussion are goals, resourcing and incentives.

Goals: Each line has different goals. They don't and shouldn't line up with each other. Management is looking to manage the risks that they own. They need to ensure that the activities that they are tasked with are done to the best of their ability to manage the risks that they own. Risk and Compliance is not there necessarily to work with or achieve the same goals as the business. They are there to ensure that the business is performing their role to the expected level.

Resourcing: There is often a debate around resourcing in relation to risk management. I.e. why are we spending all this money to manage something that might happen. That is the board's call. It is driven by the risk appetite. And the board must support this with adequate resources. If they don't then they must change their risk appetite. And the most critical area to resource is the business to support their day to day risk management efforts.

Incentives: In addition there needs to be a clear discussion around incentives and ensuring that people have the correct incentives. Incentives must hold the business accountable. They must also ensure the line 2 is incentivised to deliver on its role – which is primarily assurance back to the board. Line 3 needs to understand the boundaries of its role and also where it can add the correct value.

For me a clear example was working with a large dealer group. When we started we had the sales team responsible for identifying and onboading new adviser refusing to take responsibility for ownership of the risk with that process. Consequently the Line 2 team had grown significantly because they had no incentive to say yes – they would get all the negative. Neither team was aligned with the strategic growth goals. It took time working with the board to turn this around and ensure that the right resources and incentives were in place.



Too often risk management is not implemented until an organisation is of decent size. This is a mistake because a culture can easily get off track and it is hard then to rectify later.

Many founders are already great risk managers – they are thinking of everything – they just need to be guided.

At the very least you can implement the framework.

We find especially working with start ups that building a fit for purpose solution is fairly simple and the value is almost immediate. For example getting start up asset managers focused on understanding their operational risk around fund administration and custody usually leads them to make better decision about their outsourced partners which improves their operational efficiency keeping their costs down.

It is especially important with these businesses as they scale. Start Up Super Fund

We were working with one financial advice client who was growing rapidly and knowing that we had a 3 lines framework gave them confidence that even in that state the advice being delivered was in line with management's client service expectations.

Also don't forget that we all might find ourselves back in a small business

Line 1 - Supervision is not a dirty word

- Board must enforce ownership
- Management needs to supervise
- Supervision is running the business

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this is the crux of many issues in relation to both risk management and 3 lines of defence. The management of the business doesn't actually do any supervision. They just want to do cool things like selling the latest product.

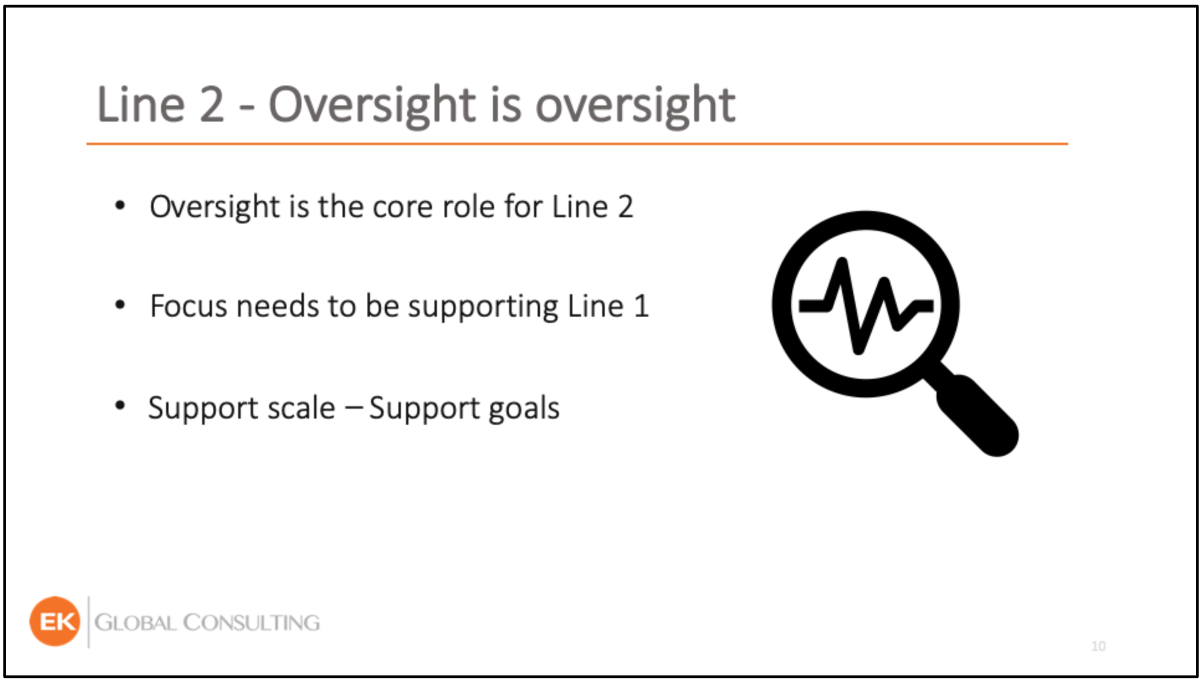
This is where the rubber hits the road. People have to do something. I think this will be the greatest failure of the royal commission in that it misses the fact the day to day supervision and the obligation to do that, and incentives linked to it, is a massive behaviour driver.

Working in the US building out the risk management frameworks there we saw great behavioural change in our branch managers once they were held accountable by the organisation and their jobs were on the line.

Supervision is running the business. It needs to be core for management and they need to own it.

The classic conversation here is but isn't that risk and compliance's job. And my response is why would you let some other group tell you how to deal with your clients or transact in your business. Grab ownership and manage it the way you want. Just as long as it is in line with the risk appetite and the goals of the organisation.

And if you can’t manage to the risk appetite then go back to the board and either get more resources or change the risk appetite.



This is where at times Risk and Compliance forget their core job. It is to perform oversight over the management and the supervision performed by that management to manage the risks that they own.

This is critical to provide assurance to the board. Don't get carried away. Do this first. This ensures the business is managing risk in alignment with the goals of the business. This is how Line 2 helps support the achievement of the business's goals.

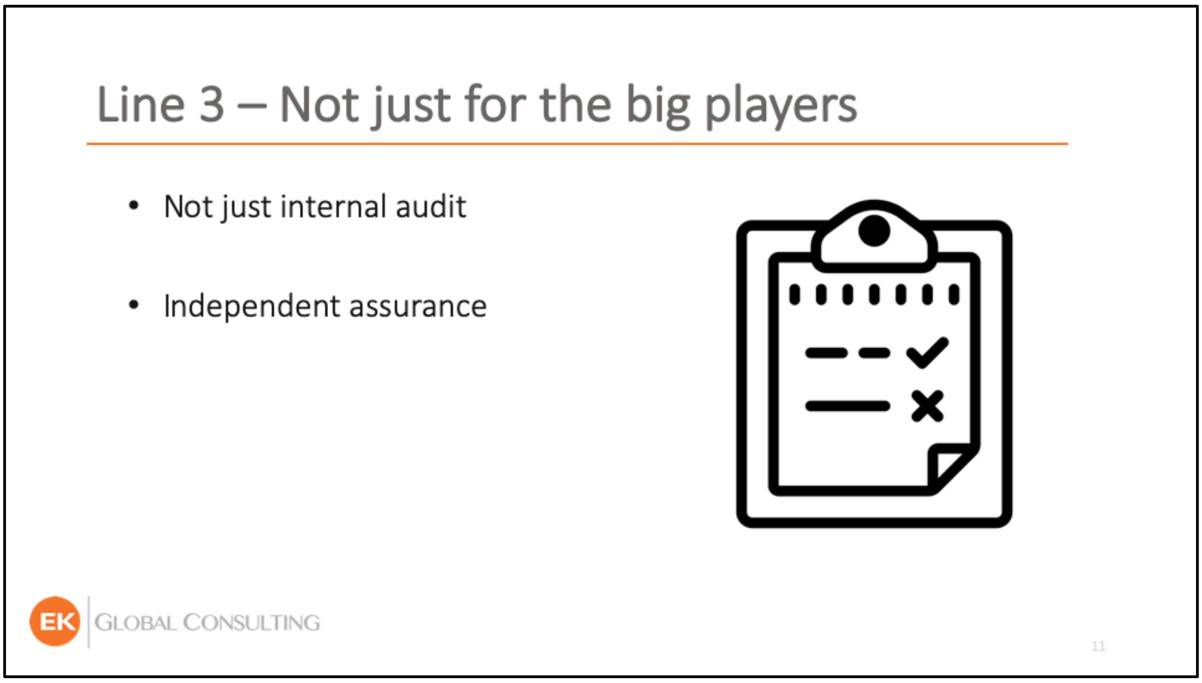
Then you can help with the other stuff.

Having said that Line 2 needs to support Line 1. It shouldn't be adversarial. This is hard and requires skills that often we don't find in Line 2 (or Line 1). Communication being possibly the most important one. The ability to be able to build and trusted relationship relies on being able to communicate effectively.

As an aside too many times I have been in situations where a CEO is asking to cut the budget for Line 2 and too often this is because of a lack of clarity over their role. Line 2 have the responsibility to clearly define their role and also resource it appropriately.

I remember working to improve the strategic plan for the risk group with an industry super CRO. What struck me first was that there was no understanding in the plan of the firm's goals. No one seemed keen to articulate this to the risk department clearly enough for them to align themselves. The second thing was that there was limited assurance that formed part of the plan. Without both these elements it was hard for the CRO to clearly explain the value of their Line 2 organisation.

Even harder for Line 2 to support the goals of the organisation.



One of the key barriers to implementing the 3 lines of defence is the challenge around Line 3.

My challenge to you all is find a way to build a line 3 solution that is fit for purpose.

Internal audit. This is the desired model but the costs and complexity are often prohibitive. In reality only big organisations have this.

However Internal Audit is only one version of independent assurance. We can be creative in finding another way.

We have found success in building this line using committees of boards with independent externals. The key is to ensure that there is scope and desire within the committee to perform that independent assurance. There is work that needs to be done that is above a normal committee of review.

The key here is to create a framework or process that will give the organisation some independent assurance that the Line 2 is operating well and not being sucked into some form of group think. To challenge the existing risk management frameworks and processes. To lead to good risk management outcomes and to hark back to the first slide to support the successful achievement of the firm's goals.

For me it is about focusing on the purpose of line 3 and not get beholden to form.

What I have been highlighting is how critical the 3 lines is to supporting strategic goals and I want to leave you with 4 key elements that I believe you need to focus on to assist with its success.

Goals: know the goals of the business and understand the barriers to achieving this. Build a Line 1 that works to manage to these goals. Build a Line 2 that lets the board know how the Line 1 is managing these risks.

Resourcing: The board must, through understanding its risk appetite, adequately resource the business across all 3 lines of defence. This is important to plan for success. It also is key to building appropriate scale across the risk management processes for the organisation.

Alignment: Each line in the 3 lines needs to be aligned with its goals and objectives and aligned to supporting the strategic goals of the business.

And finally to leave you on the element closest to my heart.

Passion: Risk Management is not just a science. We need to foster the art to help with successful implementation. We need to be more creative as practioners. We need to be more imaginative. Improve our communication skills. And finally don't hide the passion. We should be proud and passionate about risk management and ensure that we use this to drive success. Because as I said **The best chance to achieve a business's strategic goals is to manage the risks to those goals.**

Thank you.

Questions or comments?