Rethinking the Three-Line Defence
The Future of Risk in Financial Services

As financial institutions seek strategies to reduce risk management costs without impairing effectiveness, those that embrace the next generation of technology and analytics will be able to not only automate existing risk management activities but also build in controls and monitoring in a new structure optimised around data and analytics.

Julian Leake
Head of FS Risk Advisory
Deloitte UK

Edward Hida
Partner, Deloitte Advisory
Deloitte & Touche LLP, US
In the years since the financial crisis, financial institutions have faced a tsunami of regulatory requirements. New regulations have driven up compliance costs, while increased capital and liquidity requirements have reduced returns. These additional regulations have come in a period of varying economic growth, historically low interest rates, and uneven revenue opportunities, which have further reduced returns on equity and led institutions to seek to reduce operating costs including risk management costs.

Today, risk management is at a crossroads. Financial institutions need to decide if they will continue with business as usual or instead fundamentally rethink their approach to risk management.

To date, most institutions have responded piecemeal to new regulatory requirements, resulting in a disjointed and inefficient structure. Activities often take place in silos, making it difficult or impossible to gain a comprehensive view of risk management across the organisation, while increasing cost and complexity. As institutions consider how to enhance their ability to manage risk, they will benefit by considering the following six imperatives:

• Increase focus on geopolitical risks, FinTech and other non-traditional competitors and improve identification and management of these risks.

• Rethink the three lines of defence by enhancing business unit responsibility for managing risks and clarifying second line of defence activities.

• Leverage emergent technologies to increase efficiency and effectiveness of risk management.

• Establish a formal conduct and culture program to build customer trust and gain a clear strategic advantage.

• Enhance risk management capabilities to build a more nimble infrastructure able to address newer, non-financial risks as well as the challenges of regulatory fragmentation.

• Manage capital and liquidity strategically by enhancing governance structures and decision-making processes.
Increase focus on strategic risk
Institutions are entering a period of substantially greater strategic risk from a number of sources.

- Geopolitical risk has increased with the Brexit vote in the United Kingdom, the potential that populist parties in other EU countries may gain power and seek to withdraw from the European Union, and uncertainty over whether the Trump Administration will seek to renegotiate trade agreements and other alliances.

- The direction of regulation is more uncertain given recent developments in Europe and the United States. In the post-crisis environment, country regulators have also increasingly moved to protect their own national interests resulting in regulatory fragmentation due to increasingly divergent regulations which increases the complexity and costs for global financial institutions.

- FinTech startups, which leverage technology capabilities to compete with traditional financial institutions, threaten to disrupt the industry in areas such as loans, payment products, wealth management, and property and casualty insurance. In addition, there is increased competition between banks and non-banks, for example in areas where non-banks “own” the customer relationship and can leverage this relationship to provide an integrated customer financial experience.

At the same time, the ongoing varying-growth, low-interest rate economic environment is putting pressure on traditional sources of profitability. Financial institutions are increasingly searching for new avenues for growth, developing increasingly customer-centric service strategies including leveraging new technologies to provide a more targeted and pervasive customer experience. While failing to innovate in this environment may place financial institutions at a competitive disadvantage, pursuing innovation without aligning business strategies with sound risk management capabilities may also heighten strategic risks.1

In addition to having integrated strategic thinking and risk awareness, regulators expect institutions to have formalised processes to assess strategic risks to the business model stemming from technology and other changes in the external environment, as well as from their strategic choices.

Effectively managing strategic risks requires financial institutions to better integrate the stakeholders responsible for strategy and risk management; put in place processes that allow for independent oversight and challenge of strategies; train risk leaders in forward-looking risk management approaches; and implement frameworks to understand how change and uncertainty will impact key business attributes.

Financial institutions will need to conduct flexible planning including analysis of “what if” scenarios that consider the potential impact of strategic risk events on revenues and capital, and how the institution would respond. The ability to act timely on

---

the results of the “what if” scenarios will require sufficiently nimble risk infrastructure capabilities. Institutions should also consider establishing “owners” of specific strategic risks such as geopolitical, economic, and FinTech risks, who are responsible for tracking and managing these risks.

Rethink the three lines of defence model and risk alignment
Emerging technologies for testing, monitoring, and surveillance present the opportunity for a more integrated and effective model of oversight. Financial institutions that truly embrace the next generation of technology and analytics will be able to not only automate existing activities but also build in controls and monitoring in a new structure optimised around data and analytics rather than traditional front to back process flows. There could be a future where the three lines of defence model as we know it looks dramatically different.

While different institutions may move to different risk management structures, a common focus remains - institutions need to reassess the roles and responsibilities of each of the three lines of defence to reduce unnecessary complexity and redundancy, reduce costs, and increase risk management capabilities.

Do more with less
Financial institutions are seeking strategies to reduce risk management costs without impairing effectiveness. It is important that these cost control efforts are done in a strategic manner so that they do not impair the risk management capabilities required. Institutions are employing process reengineering to rationalise, standardise, and consolidate their processes, including identifying overlapping and redundant responsibilities across business activities and functions. However, reengineering efforts often focus on reducing “Run the Bank” cost and miss addressing “Change the Bank” and “Change Control” cost, which have become the faster growing cost for the industry. There are multiple levers to lower the cost of change such as model-driven development, central change governance, zero-based budgeting, project portfolio management, agile development, and automated testing. Institutions can also consider employing centres of excellence and resource sharing.
such as establishing consolidated centres for activities like testing, reporting, or model validation. Some institutions have achieved cost savings by outsourcing some processes to third-party service providers or locating them offshore.

Yet, even greater cost savings can be achieved by employing robotics process automation to automate repetitive manual activities such as regulatory reporting, assembling model validation documentation, or aspects of credit scoring. As an added bonus, automation can also reduce error rates from manual processes.

Beyond automation, advances in artificial intelligence, cognitive technologies, and data analytics can also provide greater efficiency by focusing the work of risk analysts on assessing more complex risks instead of simply sorting through and manipulating data. These technologies can provide automated decision support and data filtering to improve an organisation’s ability to detect, predict, and prevent risks. For example, robots and cognitive agents can be taught to automatically scan for new risks, raise alerts for areas of concern, and perform automated triage so that risk analysts focus on the risks that really matter.

**Establish a formal conduct and culture program**

The numerous instances of poor business practices within the financial services industry that have been exposed across the globe have resulted in clients’ interests being disregarded, unfair, and inequitable outcomes, considerable financial impact for customers, and damage to the integrity of the market. The impact of instances of misconduct has not only been felt on bottom lines and through increased regulation, it has also caused a significant loss of trust among customers and the public more broadly. Improving conduct within industry is an essential part of rebuilding trust and supporting future sustainable growth. The trust that financial institutions historically provide is a key potential differentiator as they compete with FinTech disruptors that lack a history of customer trust. Trust is also necessary for executing the customer centric strategies many financial institutions are focused on.

In the battle between incumbents and challengers, those who build (or re-build trust) faster and more effectively will gain a clear strategic advantage. Institutions that convince their shareholders that good conduct is not only ethical but also good for shareholder value in the long run will be well placed to win.

Robotic automation can limit the possibility of conduct risk by reducing the number of manual activities and making routine procedures more consistent. Beyond this, cognitive technologies and data analytics can analyse employee communications, such as emails and text messages, to identify patterns of behaviour that may be inappropriate and warrant additional investigation. However, automation and analytics can also create conduct risks if the right types of rules are not programmed into the robot’s procedures or into the analyses performed. Building conduct risk management into automation and analytics is imperative. Innovation that can help to improve the effectiveness and efficiency of conduct management programs will in turn create better customer and regulatory outcomes.

Financial institutions will need to embed conduct and culture efforts throughout the organisation and throughout their processes and governance structure, and especially at key influencing points such as customer on-boarding, new products, sales practices, training, and incentive compensation. Financial institutions may also begin to use a “carrot and stick” approach to drive behaviour. It is clear that the stakes are too high and that business as usual will no longer work.

**Enhance risk management capabilities**

Since the fiscal crisis, there has been a wide variety of regulatory requirements and guidance addressing specific risk issues such as capital adequacy, conduct risk, third-party/supplier risk, cyber security, and the quality of risk data quality, to name but a few. Institutions have often built separate processes, databases, or reports for each new requirement. As a result, while specific risk needs may have been addressed, the ability to manage risk correlation and interactions from unexpected consequences of these risk issues has not been built into the risk infrastructure or governance.
process. In many cases, investments have been driven solely by a need to comply with regulations rather than to provide business value. The regulatory and compliance approach may include labour intensive or convoluted processes and procedures that increase the chance of error and give people the incentive and opportunity to ignore controls that are designed to prevent misconduct.

To restrain costs while maintaining effective regulatory compliance and risk management capabilities, institutions will need to embrace emerging technologies. In many cases, RegTech will not only reduce costs but also provide the more timely and nimble analysis required in the new more uncertain environment.

Financial institutions will also need to continue efforts on data management programs. While a regulatory requirement, and a work in progress for many, these requirements represent a type of leading practice standard for risk data which has the capability to improve the effectiveness, timeliness, accuracy and completeness of risk analytics and information for decision making.

Rationalised risk management processes will need the capability to comply with the different regulatory requirements in different markets. This is increasingly important in a world where greater regulatory fragmentation is now the base case. Agile and adaptable systems, controls and governance will be critical. The corporate headquarters will require consistency of approach and frameworks, while allowing for varying local application that can still be assessed in a holistic manner.

**Strategically manage capital and liquidity**

Regulatory capital requirements are now a binding constraint and need to be managed effectively for institutions to improve their returns on equity. The first requirement is to develop a robust capability to measure capital and liquidity, ideally on a daily basis. The analysis should go down at least to the level of the business unit, so the institution can understand the relative capital and liquidity needs of each business unit and how the business unit contributes to the institution’s overall capital and liquidity profile.

Supported by these measurement capabilities, institutions need to strategically manage capital and liquidity and do so more dynamically than they have in the past. This will necessitate including regular capital and liquidity management evaluation into governance structures and decision-making processes. Institutions will need to build capital and liquidity measures into their strategic plans and management approaches and reevaluate them periodically. The impacts on capital and liquidity have become key considerations when institutions are deciding which businesses to compete in or which products to offer.

The six imperatives for risk management outlined above touch almost every part of an institution. Each institution will need to decide whether to continue with business as usual, running the risk of being unprepared for new risks and falling behind their peers and regulatory expectations, or seize the opportunity to take risk management to an entirely new level that truly provides the capabilities to support the organisation’s strategic plan.

While specific risk needs may have been addressed, the ability to manage risk correlation and interactions from unexpected consequences of these risk issues has not been built into the risk infrastructure or governance process.
Levers to drive change

• Focus on people. Institutions should work to ensure they have sufficient specialists with subject matter expertise on high-risk and complex activities and provide adequate training to continually upgrade skills. At the same time, they need an active program to infuse a risk aware culture in the organisation, encourage ethical behaviour by their employees, and monitor and manage conduct risk. Risk needs to move from having a reactive role to a proactive role. There needs to be a shift away from a compliance-oriented risk mindset to that of a strong and proactive risk culture. Risk practitioners across all three lines of defence need to work more closely with senior leadership to drive cultural changes across the organisation that encourage constructive challenge, ethical decision making, appropriate incentives, openness, and transparency.

• Enhance three lines of defence. Institutions should clearly define the risk management responsibilities of each line of defence, streamline the governance structure by eliminating overlapping responsibilities, and ensure that business units take full ownership of the risks in their area.

• Leverage emergent technologies. The latest technologies have the potential to fundamentally transform risk management. In addition to substantially reducing operating costs, these and other technologies can provide risk management with new capabilities including building controls directly into processes, prioritising areas for testing and monitoring, deploying automated monitoring of limits with defined escalation, addressing issues in real-time to improve the enterprise-wide view of risk, and providing decision support.

Too often previous risk structure efforts have been focused on process, not making sure that the right outcomes are delivered. Risk functions are being called to do more, but they should work to rationalise their capabilities using common infrastructure, data, processes, and governance and where possible leveraging these across both risk and finance.