Setting up a second line of defense and the art of challenge

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The risks financial institutions face are multifaceted and increasingly complex. To address these risks, large banks often maintain three lines of defense. Now, financial institutions and service organizations of all sizes are increasingly recognizing the value of adopting this model. Regulators, too, are championing the three lines of defense model. For example, the Federal Housing Finance Agency says, “Sound operational risk management practices include a three line of defense approach — business line management, an independent enterprise-level operational risk management function, and an independent review (typically conducted on a periodic basis by the entity’s internal or external auditors or qualified independent parties).”

This paper describes the value of the second line of defense, practical insights into setting one up and the art of credibly and effectively challenging the business. While drawn from experience working with financial institutions, these lessons apply to organizations of all sizes and across different industries, different operational functions (e.g., accounting, human resources, production) and different risks (e.g., reputational, operational, compliance, financial). Naturally, the second line can and should be tailored to the size and complexity of the organization.
The three lines of defense and the merits of a second line

The framework of the three lines of defense model is depicted in Figure 1 (below). Briefly:

- The first line of defense is at the line of business (LOB) operations level and involves the LOB’s own activities to control and mitigate its risks.
- The second line of defense addresses the assessment and alignment of risk management and monitoring activities with the enterprise’s risk and control framework. The second line oversees management and monitoring of the first line’s risk-taking, mitigation and management activities.
- The third line of defense is the internal audit function. Periodically, internal audit reviews and tests various aspects of operations.

Figure 1
The three lines of defense in effective risk management and control

The second line has two main responsibilities:
1) Challenge the design effectiveness of the first line’s mitigation and management of risk-taking activities
2) Test the implementation effectiveness of the first line’s risk mitigation and management activities

The second line bridges gaps between the first and third lines. While the first line is well-positioned to identify and control many risks, it may:

- Be too close to risks to design effective mitigation activities
- Consider risk mitigation to be overhead and treat it like a secondary activity
- Not be objective when risk mitigation activities result in self-incrimination

Meanwhile, the third line provides vital objective testing, but:

- Tests only periodically and always after the fact
- May conduct narrower tests
- May test compliance, rather than risk mitigation activities

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The art of challenge by the second line

The authority and ability to effectively challenge the first line is vital to an effective second line. To ensure this ability, operational risk management programs should have a board-approved “governance with well-defined lines of responsibility, and establishing and maintaining robust challenge mechanisms and issue-tracking processes designed to escalate issues as necessary to ensure resolution.”

There is a balance between effective challenge and compliance within the different lines of defense. Where compliance is mandatory in the first and third lines, challenge is mandatory in the second line. While management relies on the first and third lines to ensure compliance with regulations, policies and procedures, it depends on the second line for a pragmatic review of risk within the organization (Figure 2).

<table>
<thead>
<tr>
<th>Line of defense</th>
<th>Effective challenge</th>
<th>Test compliance</th>
</tr>
</thead>
<tbody>
<tr>
<td>First</td>
<td>Optional</td>
<td>Mandatory</td>
</tr>
<tr>
<td>Second</td>
<td>Mandatory</td>
<td>Optional</td>
</tr>
<tr>
<td>Third</td>
<td>Optional</td>
<td>Mandatory</td>
</tr>
</tbody>
</table>

When effective challenge is required

The second line conducts three kinds of challenges—transactional, regulatory and conceptual:

- **Transactional.** The second line should review basic transactions to ensure procedures were properly and accurately conducted. For example, the second line can ensure required approvals were obtained, appropriate meetings were held and mathematical calculations were performed correctly. Transactional challenges are generally not very complex.
- **Regulatory.** The second line should review compliance with applicable regulations. Regulatory challenges generally involve more complex assessment activities and requirements than transactional challenges.
- **Conceptual.** The second line should proactively challenge the conceptual framework of the organization’s risk-taking and management activities. Conceptual challenges are the most complex challenge activities and require the ability to apply industry knowledge of the business. Conceptual challenge activities correlate and compare outcomes and risks across business entities. Conceptual challenges look beyond current operations to identify future risks. In essence, conceptual challenges are a common-sense approach to assessing and managing business risks (Figure 3).

Figure 3

The art of effective challenge

- **Scope and depth**

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Designing and implementing a second line of defense

Setting up a second line of defense is a three-phase process:

- Phase I. Information gathering and planning
- Phase II. Trial run(s) and adjustments of planned activities
- Phase III. Implementation of adjusted activities

The following is an abbreviated methodology for setting up a second line of defense (Figure 4):

Phase I
1. Establish the second line’s sponsor, authority, scope and objectives.
2. Meet with the first line to achieve a mutual understanding of the second line’s purpose and gain a clear understanding of the first line’s objective(s) and responsibilities. Step two includes a review of any procedures conducted by third-party vendors and the first line’s third-party vendor policies and procedures.
3. Determine the critical risks presented by the first line, including determining what first-line functions are deemed in and out of scope. For example, administrative functions, such as personnel competency, capacity and performance evaluation, and the integrity of data received by the first line from others may be deemed out of scope.
4. Gain an understanding of the first line’s current written and implemented policies and procedures through meetings and reading documents.
5. Identify the presence or absence of key controls for critical risks within the first line, including consideration of any after-the-fact quality assurance procedures conducted by the first line.
6. Formulate tentative challenges to existing first-line policies, procedures and controls. This step is ongoing. After the initial assessment of all first-line policies and procedures, the second line will continue to assess any changes to first-line policies and procedures (or the absence of expected changes).
7. Design the second line’s tentative, periodic first-line monitoring, testing and reporting activities and timing. Document tentative second-line policies and procedures. This step includes obtaining approval of significant second-line policies and procedures from the second line’s sponsor and periodic updating of the sponsor on the status of second-line implementation and results.
8. Mutually agree with the first line on the second line’s monitoring, testing and reporting activities and timing and revise tentative second-line policies and procedures.

Phase II
9. Receive monitoring information from the first line.
10. Conduct initial first-line testing.
11. Evaluate testing results, including challenges to effectiveness of first-line policies, procedures and controls. As in step seven, this includes updating and obtaining approval from the second line’s sponsor.
12. Produce and deliver initial first-line effectiveness reporting.
13. Resolve effectiveness challenges with first-line and agree on remediation action plans, including determining whether any systemic first-line root causes require remediation.
14. Finalize tentative first-line design challenges and discuss with the first line.
15. Design and produce second-line management reporting.
16. Design and conduct second-line self-audit procedures, including reporting and remediation actions.

Phase III
17. Adjust steps 7–8 and 9–15, as necessary, based on Phase 2 results.
18. Repeat Phases 1 and 2 on the agreed-to periodic schedule, making future changes as needed.
12 practical tips

In designing and implementing a second line, the following 12 tips will help improve results:

- **Assess the compliance culture.** The second line’s implementation strategy will vary, depending on the attitudes of the organization and the first line toward addressing compliance. The compliance culture helps predict how receptive the first line will be to a second line and how much support may be received from management.
  - **Action:** Implementation strategy should be adjusted accordingly.

- **Don’t confuse the second line with the first line.** The second line should not design its procedures to substitute or compensate for deficiencies in the first line. The second line’s responsibility is to oversee the first line’s activities. If the first line does not perform adequate risk mitigation activities, then the second line’s first effective challenge should be to push the first line to design and implement better risk mitigation activities.
  - **Action:** The second line should oversee the first line’s risk mitigation activities, not substitute for them.

- **Develop a cohesive relationship with the first line.** The relationship between the first line and the second line should be player-coach, not player-referee. The second line’s role is not to penalize the first line; it is to help the first line avoid penalties. The first line’s initial reaction to oversight will naturally be defensive. Acting as a coach, not a critic, will break down this natural resistance.
  - **Action:** Make sure the first line understands that the relationship will be a team effort.

- **Make it the first line’s idea.** The second line should take advantage of the first line’s knowledge of its business and risks and not impose rote or preconceived procedures.
  - **Action:** Explain the second line’s objectives and discuss the first line’s ideas about what oversight procedures would best accomplish those objectives. In most cases, the first line’s ideas will comprise most of what is eventually agreed to.

- **Over communicate.** At each significant design stage, discuss drafts with the first line. Getting quality feedback and buy-in from the first line is more likely when the first line is presented with one or two items to review, rather than multiple steps and documents at one time. The technique also keeps the second line visible, which keeps the first line from thinking the second line is developing a process in a vacuum.
  - **Action:** Establish continuous and frequent touch points between the first and second lines.

- **Don’t mix design and application.** During the design phase, as you gain an understanding of the first line’s policies and procedures, you will undoubtedly come across needed improvements in the first line’s activities. Some may be significant. Resist the urge to make piecemeal challenges to the first line (unless they are critical and require immediate attention). Hold those challenges until the second line has gathered all of its information and has begun to implement second-line procedures.
  - **Action:** Prioritize challenges and introduce them to the first line as part of the second line’s recurring oversight activities.

- **Don’t jump to conclusions; allow for rebuttal.** Before concluding that a first-line policy or procedure is deficient, ask the first line for their reasoning. In many cases, the first line will recognize the deficiency themselves. Before concluding on a deficiency, allow the first line to rebut the finding. Many times, the second-line finding is rebuttable. In cases where the second-line finding is valid, the first line will realize that themselves during their rebuttal research.
  - **Action:** Before finalizing conclusions, ask the first line to explain policies or procedures that appear deficient in design or effectiveness. This approach reinforces a team concept.
• **Documentation is key.** The first line’s policies, procedures and decisions will be less susceptible to questioning and be more defensible when the rationale for judgments is documented. Inevitably, the second line, third line, regulator or other party will have a different opinion of how something should be handled.
  - Action: Document the reasoning where policies and procedures do not follow expected standards. This will assist in explaining the departure to other interested parties.

• **Don’t upset the apple cart.** Throughout the design process, try to adopt the communications procedures and formats used by the first line and the rest of the company. This will help smooth implementation.
  - Action: Base second-line communication protocols on first-line and company protocols.

• **Establish a timetable.** Work with the first line to establish a mutually agreed-upon timetable for the second-line’s cycle of activities. Obtaining explicit agreement will help obligate the first line to honor its commitment and prevent procrastination. It is imperative that each cycle of activity be closed out on schedule to permit timely second-line analysis and reporting.
  - Action: The first and second lines should set and agree upon timetables and activity cycles.

• **Be patient.** An orderly implementation will probably take at least three months. The first month will be devoted to gathering information about the first line’s risks and activities, drafting second-line policies and procedures and conducting some practice runs. The second month will be devoted to incorporating findings from the practice runs and a full shakeout application. Policies and procedures will not be applied in a mature, steady-state manner until the third month.
  - Action: Implement second-line policies and procedures in an orderly fashion.

• **No findings, no harm.** The second line doesn’t need to find first-line deficiencies to be doing its job. If the second line finds that the first line has designed effective risk mitigation activities and is implementing them effectively, then the second line is fulfilling its responsibilities. In fact, that is the ideal outcome.
  - Action: The second line assesses the first line’s risk mitigation design and implementation activities for effectiveness.

Creating a second line of defense is more easily said than done. Personal styles, skepticism, conflicting priorities, judgment calls and details all slow down the process. But these snags help ensure that the end result is well-designed and that all parties buy into the outcome. The processes and tips provided above can help your company implement an efficient and effective second line of defense.