Session 3C: First Line, Second Line, Third Line? Whose Line is it Anyway?

**Moderator:**
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**Presenters:**
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Joanna O’Neill
Whose Line is it Anyway?
Topics

• Overview of the 3 Lines of Defense Model
• Factors Influencing the design of governance models
• Risk and Compliance functions
• Group vs. Business Units
• Scenarios – Voting
• Summary
Presenter Information

<table>
<thead>
<tr>
<th>Team Member</th>
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| **Brian O’Neill**  
CERA, CFA, FSA, MAAA  
Senior Manager  
Deloitte Consulting LLP  
| Brian is a Senior Manager in the insurance consulting practice at Deloitte. Brian has extensive experience developing robust Economic Capital Modeling (ECM) and Asset Liability Management (ALM) functions and implementing these functions into the larger ERM framework of insurance organizations. Brian has worked with large and small organizations and has worked with both direct carriers and reinsurers in performing these projects. Brian is a Fellow in the Society of Actuaries (FSA), a member of the American Academy of Actuaries (MAAA), a Chartered Financial Analyst (CFA), and a Chartered Enterprise Risk Analyst (CERA). He is the Chair of the Life Operational Risk Work Group for the American Academy of Actuaries. |
| **Joanna O’Neill**  
MBA, ARM, CPCU  
Risk Advisory Manager  
Deloitte & Touche, LLP  
| Joanna has 12 years experience in providing enterprise risk management (ERM) and Operational Risk advisory services to insurance companies. She has served in management roles including Assistant Director for a Corporate Risk Institute with executive Board members from Industry and Academia. She started her career in a national property and casualty company and has since been in various insurance risk consulting roles, leading national and global projects. Joanna has provided risk management solutions including designing ERM and Operational Risk programs, governance reviews, executive risk communication & reporting guidance, rating agency and risk regulation optimization, and utilizing GRC technology to support her clients’ risk management processes. |
Three Lines of Defense

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<thead>
<tr>
<th>First line of defense</th>
<th>Second line of defense</th>
<th>Third line of defense</th>
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<tbody>
<tr>
<td><strong>Board of Directors</strong></td>
<td><strong>Top management and new business development</strong></td>
<td><strong>Risk management function</strong></td>
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<td><strong>Internal audit</strong></td>
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<td><strong>External auditor</strong></td>
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<td><strong>Regulator</strong></td>
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Risk management responsibility can be viewed as three lines of defense:

**First line of defense**
- Promote a strong risk culture and sustainable risk-return decision making
- Portfolio optimization on the macro and micro level
- Promote a strong culture of adhering to limits and managing risk exposure
- Ongoing assessment and monitoring of risks

**Second line of defense**
- Combination of watchdog, trusted advisor, enforcer
- Understand how the business makes money—and actively challenge initiatives if appropriate
- Independent from management and staff that originate risk exposures
- Overarching risk oversight unit across all risk types and business units

**Third line of defense**
- Good understanding of the business and risk management
- Challenge the front office and risk management function
- Independent oversight function with ability to enforce fulfillment of findings
- Ability to link business and risk with process and IT know-how
## Design of Risk Governance Models

### Key areas of market divergence in relation to the allocation of responsibilities

<table>
<thead>
<tr>
<th>Advisory</th>
<th>2nd Line materially involved in decision making vs. oversight and monitoring with little, if any, advisory or decision making</th>
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<tbody>
<tr>
<td>Capital modelling and validation</td>
<td>First Line vs. 2nd Line performing modelling and validation activity</td>
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<td>Own Risk Solvency Assessment</td>
<td>First Line Finance Function role vs. 2nd Line Risk role</td>
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<td>Risk processes</td>
<td>Process execution vs. Process oversight</td>
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<td>Reporting</td>
<td>Risk reporting responsibility quantitative vs. qualitative</td>
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<td>Risk technology</td>
<td>Ownership of risk technology</td>
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### Key factors to consider include

- The size, complexity and risk profile of the group
- The level of independence required in relation to the assignment of conflicting roles e.g. the design and development of risk models versus their validation
- The availability of specialist resource and / or the need to optimise the use of specialist resource e.g. actuarial
- The maturity of the risk management practices
- The need for specific / sophisticated risk management approaches that are more closely aligned to the nature and complexity of a given business and / or local regulatory requirements

The principles of the ‘three lines of defense’ governance model have been widely adopted by firms who have tailored their approaches resulting in differing allocations of functions that sit in 1st and 2nd lines, as well as differing allocations of risk management responsibilities.
High Level Risk and Compliance Design Options

A variety of high level design options exist in relation to the positioning of Risk and Compliance functions. Key examples are set out including the related potential benefits and concerns of the approach which would need to be tailored and enhanced to better reflect the nature of the firm.
Control Functions - Interrelationships

**Group control**

- Local control functions within the businesses report directly to Group who oversee and control their activities
- The local control functions within the businesses provide reports to local management and Group on local risk control related matters

**Potential benefits**
- Increased independence of the local control functions within the 2nd line of defence
- Better enables the consistent application of Group defined risk control practices across the group as well as the consistent reporting of risk control information

**Potential concerns**
- May dilute 1st line accountability for the management of risk within their business
- Group defined risk control practices and reporting may need to be tailored/augmented in order to meet any more specific local regulatory requirements and/or business needs
- May result in inefficiencies arising from multiple levels of review and challenge

**Local management control**

- Local control functions report independently and directly to local management who direct and control their activities
- Whilst there is flow of information between the Group and business level functions, there is no formal reporting relationship between these functions

**Potential benefits**
- Helps maintain / reinforce 1st line of defence accountability for the management of risk within their business
- Better enables risk control practices and reporting to be tailored/augmented in order to meet any more specific local regulatory requirements and/or business needs

**Potential concerns**
- Working under the direction and control of local management may dilute the independence of the local control functions
- May result in the inconsistent application of Group defined risk control practices across the group as well as inconsistent reporting of risk control information
Polling Scenarios

• To be provided during the session