The Three Lines of Control – An Adaptation for Financial Services

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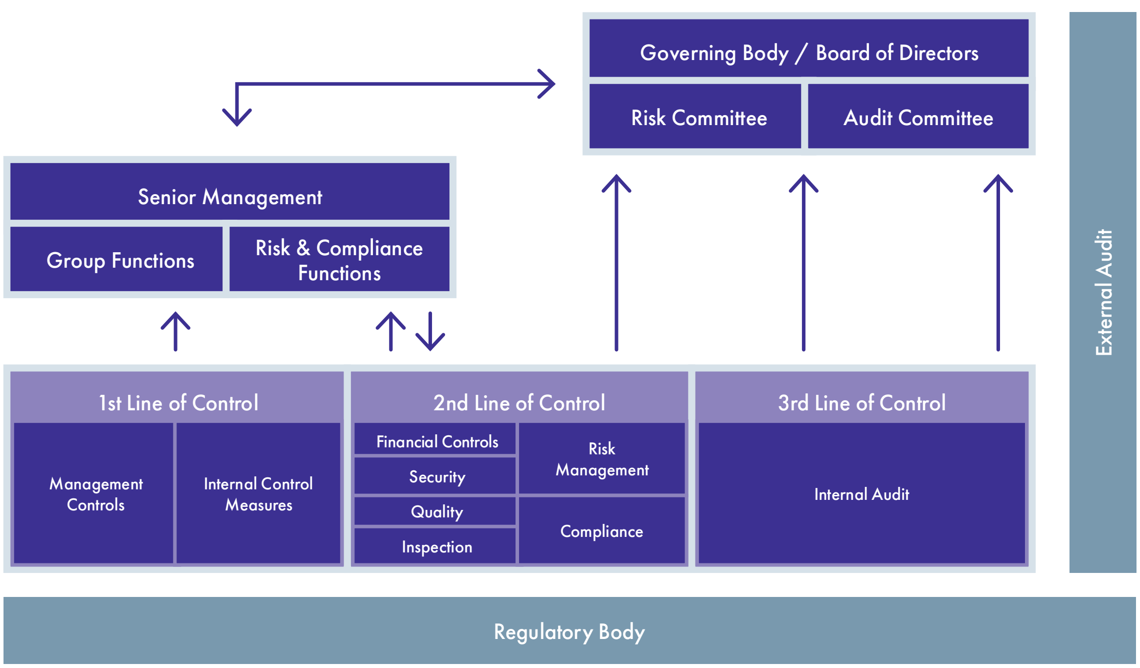
The board of directors of financial service providers is exposed to its regulatory environment with a number of control and compliance processes, requiring follow-up activities on an operational and formal level. The Three Lines of Defense Model (TLDM), introduced by the Institute of Internal Auditors (IIA) in 2013, has become a role model for mapping and organizing control and supervisory functions – inside and outside the organization. However, the model is not without criticism. Science and practice jointly demand a revised model that reflects (economically) new, up-to-date theories. Only then, practical and meaningful benefits are created in order to fulfil the inalienable duties according to art. 716a CO. More precisely, it appears that the TLDM fails to reflect prescribed laws, guidelines and certain dynamics in practice. The application of the model in different industries and areas and the corresponding general, simple character of the design are probably the most obvious reasons (Leech & Hanlon, 2016, p. 335). As risk, compliance and internal audit issues have become the core of control and performance, it is time to take account of these factors by a revised version (as outlined below): **The Three Lines of Control Model (TLCM)**.



The Three Lines of Control Model (Germann & Sutter-Rüdisser, 2019)

The TLCM sets new guidelines and aligns with recognized hard and soft law standards. In detail, the authors consider three corporate governance implications that need to be extended:

1. **Regulator:** The regulator takes a central role in defining the organization, particularly with regard to the organizational structure and its corresponding risk assessment. Financial service regulations have a direct impact on the company structure and the way they are conducting their business. It is therefore time to assign the regulatory experts a more central and fundamental role and to embed the authorities more effectively into the corporate setting. Seeing the state as a supporting entity may also change the perception of how to define the role of the government; changing from an outsider to a sparring partner.

2. **Resource Deployment of Risk Management, Compliance and ICS:** Based on the comprehensive regulatory apparatus (e.g. Basel III), risk management, compliance and ICS play an overriding role and require greater attention to ensure the effectiveness and efficiency of the necessary control measures. It is the exclusive responsibility of the board of directors/ the committees to provide – the earlier the better – the three functions with appropriate (human) resources and competencies (indicated by the size of the boxes). All three are effective and not to be underestimated instruments for determining and monitoring risk appetite.

3. **Risk and Audit Committee Separation and Reporting Lines:** The TLCM proposes a formal separation of the risk and audit committee with individual reporting lines to the management and to the business functions. The purpose first, is to make room for an appropriate partner in complex business environments and, second, to provide formal reporting lines for activities requiring ad-hoc decision-making or of such materiality that board involvement becomes necessary. Likewise, such a structure promotes the collaboration and exchange of information between the business areas and the committees or the board of directors, respectively. However, communication shall not be randomly assessed but should follow formal, purposeful internal guidelines.

Last but not least, the model follows a more agile and active approach, proposed by the change of name from defense to control. Control is more proactive, promoting the positive attitude of communication and personal interaction between different levels of the entity. A framework that aims at initiating measures in advance.

Adapting to new and constantly changing requirements can be unsettling but is a must in order to be best in class within the field of corporate governance. The TCLM provides a framework for identifying areas that need special attention in advance (on a vertical and hierarchical level).