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THE THREE LINES OF DEFENSE MODEL ESTABLISH EFFECTIVE GOVERNANCE, RISK MANAGEMENT AND COMPLIANCE IN FINANCIAL INSTITUTIONS: AN INTERNATIONAL CROSS-COMPARISON OF UK, EUROPE, US AND AUSTRALIA

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Abstract

In recent years, the corporate world has made a concerted effort to invest in risk management, governance processes, and compliance. We examine the determinants and challenges faced by various governance stakeholders when implementing the three lines of defense model in this paper (TLoD). The purpose of this paper is to examine the relationship between board characteristics, risk management disclosure, and compliances of companies operating in the financial services sector in the United Kingdom, European countries, the United States of America, and Australia. This is a qualitative study using the analytical descriptive method, which is a technique that entails not only data collection but also data analysis and interpretation. This paper demonstrates that management of any financial institution is critical for implementing the three lines of defense (TLoD) model, not only due to the magnitude and complexity of the issues at hand, but also because they bear full responsibility for risk management that is proper, effective, conscientious, and dedicated, as this is a critical precondition for achieving sustainable success.

Keywords: Effective Governance, Risk Management, Compliance, Financial Institutions

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INTRODUCTION

In recent years, there have been increasing efforts in the corporate world to invest in risk management, governance processes and compliance. In this paper, we examine this study analyses determinants and challenges between different governance stakeholders in implementing the three lines of defense model (TLoD). Despite much debate about bank risk management and its purported failure during the financial crisis, the basic patterns of risk management in financial institutions are not known and the main determinants of banks' risk management are not well understood (Malik et al., 2020).. Since financial institutions play a key role in the macroeconomy and in the transmission of monetary policy, understanding their exposure to shocks is essential for monetary and macro-prudential policy (Rampini et al., 2020).

The relationship between the board of directors' key governance characteristics, risk management disclosure, and financial variables/firm profitability is a hot topic of research that has received little attention in the literature. These credentials are also at the heart of numerous studies, highlighting the critical role of board characteristics such as independence, size, background and skills, structure, and diversity—associated with corporate governance (CG) and sustainable development activities—in shaping the financial performance of businesses, particularly those in the financial services sector (Noja et al., 2021)

The financial institutions can manage the risk exposures arising from lending and deposit-taking activities using financial derivatives. Indeed, financial institutions are the largest users of derivatives, measured in terms of gross notional exposures. For example, risk management in U.S. financial institutions using panel data on interest rate and foreign exchange rate derivatives positions, which represent on average 94% and 5% of the notional value of all derivatives used for hedging, that is, almost all of the derivatives that financial institutions use for hedging purposes. Indeed, financial institutions are the largest users of derivatives, measured in terms of gross notional exposures (Rampini et al., 2020).

The relationship between board characteristics and risk management is illustrated by the critical role of effective corporate governance mechanisms in limiting an organization's excessive risk exposure, particularly in the financial services sector (Bunea & Dinu, 2019). Additionally, the relationship between effective governance, risk management, and financial performance is hotly debated in the literature, as evidenced by the critical role of the corporate governance board in supervising the company's activities and decision-making processes, thereby affecting the capability to successfully engage in achieving the firm's objectives with spillover effects on firm profitability and overall performance (Noja et al., 2021).

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The purpose of this paper is to examine the relationship between board characteristics, risk management disclosure, and compliances of companies operating in the financial services sector in the United Kingdom, European countries, the United States of America, and Australia. As a result, it is set to provide additional evidence that board characteristics, particularly board size, board skills/capabilities, diversity, and independence, are critical pillars of risk management and leveraged performance, being required for accurate and effective management strategies, as well as CG and sustainable development activities.

The paper contributes significantly to the literature by providing a comprehensive view of the interconnections and correlations between several critical fundamentals of effective governance, risk management, and compliance (a three-tiered approach) in the financial services sector, based on advanced empirical analysis. As such, it provides compelling evidence on the relationship between board size, structure, diversity, background, and skills (positively or negatively) with financial risk management in the presence of independent corporate governance, as well as their cumulative compliance.

LITERATURE REVIEW

Effective Corporate Governance

Effective corporate governance is defined by an organization's unwavering commitment to and adoption of ethical practices throughout its value chain, in all of its interactions with a diverse group of stakeholders, including employees, customers, vendors, regulators, and shareholders (including minority shareholders). To accomplish this, certain checks and balances must be fully implemented. Trust and integrity are critical components of economic life, and both boards of directors and management must work to ensure that these characteristics are quickly recognized and practiced throughout the organization (Mohamad, 2018)

Risk Management

Risk can also refer to unplanned events that result in reduced earnings or loss, according to (Aloqab et al., 2018). Any activity or operation that generates profits or losses is considered a risky proposition due to the unpredictability or uncertainty inherent in the trading activity. In simpler terms, risk is defined as the unknown nature of an outcome (Chang et al., 2020). While the terms uncertainty and risk are frequently used interchangeably, there is a distinction between the two. Sharan) In business, uncertainty refers to a situation in which a decision-maker is aware of and aware of the expected outcomes of a particular action. Risks, by definition, are quantifiable uncertainties (Guest, 2021).

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Aloqab et al argue that risk management are not unique to financial institutions, and there is a growing global need to manage this in the modern era. Financial institutions worldwide are developing risk management systems, and the majority of them are aiming for increased risk management and reallocation efficiency. The primary objective of risk management in a financial institution is to identify the risks that the institution is likely to encounter during its operations. One way to mitigate these risks is to set aside funds for unforeseen and possible losses (Aloqab et al., 2018)

Risk Disclosure Compliance

Compliance with risk disclosure requirements is critical for all organizations in developed and developing economies, promotes transparency by adhering to existing risk regulations and enhancing the quality of risk information. Based on Nkuutu's research (Nkuutu et al., 2020), effective board governance has a significant impact on service firm performance while Nalukenge et al. indicate that behavioral corporate governance has a positive influence on compliance (Bananuka et al., 2018).

RESEARCH METHOD

Research Design

This is a qualitative study that employs the analytical descriptive method, which is a technique that encompasses not only data collection but also data analysis and interpretation. The analytical descriptive method collects data, which is then analyzed and interpreted in accordance with the research objectives. According to Sugiyono, qualitative research has the following characteristics: it is conducted under natural conditions (as opposed to an. experiment), directly with the data source, and the researcher is the primary instrument; qualitative research is more descriptive in nature; the data collected is in the form of words or pictures, rather than numbers; qualitative research places an emphasis on process rather than product or outcome; qualitative research conducts (Sugiyono, 2016).

Source of Data

Researchers use internet media to collect journals, articles and digital books which are used as data sources.

Research Data

The research in this study is Financial Institutions: An International Cross-comparison of UK, Europe, US and Australia.

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Research Instrument

In this qualitative study, the researcher is the primary instrument. Additionally, researchers require additional instruments for this study, including analysis sheets, observations, and documents (newspapers). The following provides an overview of the instrument.

Data Collection Technique

The technique that the author uses to collect research data includes three stages, namely orientation, selection, and identification. The researchers conduct orientation to identify and comprehend the subject of the research as well as the data that has been collected in online databases and article journals. The researchers select the data to be analyzed by identifying the source of the data. The researchers identify data sources following their selection. The data that will be analyzed is determined based on the data sources that have been chosen.

Analysis Technique

The Miles and Huberman model was used to analyze the data. According to Miles and Huberman (Miles & Saldana, 2014), the steps of qualitative data analysis are as follows: a) data reduction, which entails sorting, classifying, and parsing data to a saturation point; b) data display (data presentation), which entails presenting reduced data to be analyzed using criteria; and c) drawing conclusions.

Table 1. Summary of the literature review conducted by the researcher

No	Researcher	Title	Purpose	Result
1	(Khan, 2018)	Risk Management Disclosure: Evidence from the UK Banks	To examine the extent to which RMD has changed in annual financial reports filed by UK banks.	There is a growing demand for enhanced corporate disclosures to stakeholders, particularly regarding risk management (RMD). The findings indicate that the volume of RMD has been increasing significantly in the selected banks as a result of regulations and increased stakeholder pressure following the financial crisis. To avoid agency costs and crises, there is a need for more sound regulation regarding risk information disclosure.

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2	(Li & Zou, 2014)	The impact of credit risk management on profitability of commercial banks: A study of Europe	To disseminate accurate information to stakeholders about a financial institution's credit risk management practices and their impact on profitability.	Because credit risk management and profitability are positively correlated, the researchers recommend that financial institutions devote additional resources to credit risk management. That is, managers should be more precise in their assessment of borrowers' ability to repay.
3	(Saksonova & Kuzmina-Merlino, 2017)	Fintech as financial innovation - The possibilities and problems of implementation	To evaluate technology's level of development of financial institutions in Europe	The survey results support this hypothesis by indicating that respondents are generally unaware of Latvian and European technology services, as well as associated innovations and new financial products.
4	(Frank & Greenman, 2020)	Revisiting conduct risk management in the covid-19 era with updated doj criteria	To analyze the impact that financial institutions make on the world's financial markets especially in US.	Financial institutions have always been responsible for managing conduct risk. Conduct risk has come under increased scrutiny in the years since the financial crisis, as regulators in various jurisdictions expanded requirements to address various types of misconduct. This research concludes that it is critical to involve stakeholders from both first and second line of defense business units and control functions. Firms should meticulously document their efforts to mitigate conduct risk and foster a culture of compliance and integrity, ensuring that the organization receives full credit for its efforts to prevent and detect misconduct in the event of a regulatory investigation.
5	(Roky et al., 2020)	Computational evaluation of profitability: A case	To conduct a thorough examination of Australian financial	The findings indicate that the failure of one bank can result in the failure of other banks, causing distress

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	of Australian banks	institutions especially banks in terms of profitability and competitiveness.	throughout the banking system. Occasionally, it can even have a greater international impact, as demonstrated by the Global Financial Crisis.

RESULTS & DISCUSSION

It is uncommon to find research on the TLoD's implementation and associated challenges. Chambers and Odar (2015, p. 49) conclude after analyzing the financial crisis that the "three lines of defense approach" was ineffective and created a false sense of security (Chambers & Odar, 2015). In a similar vein, the Common Body of Knowledge (CBOK) data base, which is the world's largest ongoing study of finance, identifies evidence of ineffective implementation efforts. It is worth noting that 13% of respondents in Europe are unfamiliar with the TLoD, rising to 20% globally (Huibers, 2015). Other research conducted a survey of Dutch banks and concluded that while the TLoD's design is sound, numerous implementation and operational issues can be identified. He identified five impediments to the TLoD's successful implementation. These include ambiguous accountability, a lack of first-line accountability, lines operating in isolation, a lack of countervailing power, and a static model operating in a dynamic environment. It also focuses on the risk function and individual components, such as risk culture (Braumann, 2018). Luburic (2017) confirms through an analysis of central banks that the TLoD is primarily dependent on effective communication between the lines. He argues for enlarging each line, which expands the number of connections and communication topics (Luburić, 2017). As a result, vertical and horizontal coordination of all aspects of risk management is a critical condition for ensuring the TLoD's successful implementation and operation.

According to Davies and Zhivitskaya's (2018) analysis of the TLoD's critics, ever-increasing layers of oversight may jeopardize business efficiency and customer service. Additionally, the existence of three distinct groups charged with ensuring proper risk-taking behavior may have created a false sense of security. They request an appropriate implementation strategy, which includes clarity regarding the boundaries of the three lines and an understanding of the relationship between the first and second lines (Davies & Zhivitskaya, 2018). Additionally, financial firms confirm that businesses suffer from a disorganized TLoD. This may result in the following challenges (EY, 2013) (PWC, 2017): inconsistent and redundant reporting, risk coverage gaps, siloed risk functions, business fatigue, confusion about the organization's risk profile, and layers of redundant controls. Professional organizations request coordination among various assurance providers but recognize that implementation is

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uncommon due to a variety of obstacles (ECIIA, 2009; IIA UK and Ireland, 2010) in (Aditya et al., 2021); (Bantleon et al., 2021). Additionally, the COSO Enterprise Risk Management–Integrated Framework emphasizes the importance of coordinating "risk, compliance, control, and even governance activities" in order to control risk management costs (COSO, 2017).

By incorporating Standard 2050 "Coordination and Reliance" into the International Professional Practice Framework (IPPF) in 2017, the fundamental concept was incorporated into the IPPF. However, there are currently impediments to the IAF relying on others (lack of maturity among the first and second lines of defense, concerns about impairing the IAF's independence and objectivity, lack of alignment in risk definition and risk management, and a lack of prescriptive guidance for evaluating the lines of defense) (Pett & Poritz, 2018).

According to Luburic's reseach, along with risk management principles, the strengthening of the three lines of defense model incorporates effective governance principles and approaches to Risk disclosure compliance, as well as a variety of economic, social, cultural, psychological, and technical aspects that require systematic alignment (Luburic et al., 2015). The strengthening has not resulted in a loss of functionality for TLoD model; rather, it has added new features to the base model. The first line of defense has altered the content and method of work, significantly increasing employee engagement as process and risk owners in an organization, encouraging them to become more actively involved in risk mitigation. Because process owners and risk owners exist at all levels of an organization's management, the second line of defense must be strengthened in order to contribute effectively to management and employee success via infrastructure support and training. In this context, the third line of defense strengthens control by ensuring that the first and second lines of defense operate properly and effectively to manage the organization as efficiently as possible. A successful operation of the three lines of defense requires excellent communication between them, as the number of connections and communication topics increases as the lines of defense are strengthened.

The coordination of the strengthened model of three lines of defense, which is at the forefront of risk management, is built into the system and logic that reinforce the fundamental model, most notably through the incorporation of quality management principles and requirements, risk management principles, and a total quality management approach. Model coordination is a process that has a significant impact on the generation of an organization's success, but it also comes with its own risks and implementation and performance evaluation tools. Harmonization and coordination can be examined by examining the process of developing and implementing quality and risk policies, as well as their dissemination throughout the organization (Luburić, 2017).

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Quality and risk policies establish broad and measurable objectives that take into account the organization's internal and external contexts, guiding its future course toward risk. Processes and activities are defined and planned in accordance with the objectives and identified requirements, needs, and expectations of users and other interested parties, who implement them within specified deadlines. This means that the process of developing quality and risk policies, communicating them to all levels of governance, and implementing them is a process or a collection of processes organized as a network. It should be noted that just as the establishment of processes, plans, and activities is a process, so is the definition of goals and measurable objectives. All of these processes and networks of processes have process owners and risk owners who coordinate activities through the institute of management review. Because decisions are made on the basis of facts, quality methods and techniques are applied at the network of processes level, the process level, and the operation level. Utilizing the methods and techniques significantly assists in competently challenging the arguments, as well as in the effective implementation of coordination and harmonisation (Luburić, 2017).

The strengthened model of three lines of defense envisions communication and coordination both vertically and horizontally in the same manner as previously used - through management review and other forms recommended by total quality management approaches. Management review occurs at all levels of management as well as at the process or network level. While a management review conducted in accordance with standards is generally concerned with quality, the review itself is concerned with both quality and risk, as the "strengthening" does not distinguish between the two. It should be noted that because review is a natural part of modern leadership, this approach to operational risk management becomes a daily necessity and an indispensable approach.

CONCLUSION

Along with risk management principles, the strengthening of the three lines of defense model incorporates effective governance principles and approaches to risk disclosure compliance, as well as a variety of economic, social, cultural, psychological, and technical factors that must be coordinated in a systematic manner. The third line of defense strengthens control in this study by ensuring that the first and second lines of defense function properly and effectively in order to manage the organization as efficiently as possible. Achieving success with the three lines of defense requires excellent communication between them, as the number of connections and communication topics increases as the lines of defense are strengthened. Along with risk management principles, the strengthening of the three lines of defense model

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incorporates quality management principles and approaches to total quality management, as well as a variety of other factors that require systematic alignment.

For further research; there are a number of gaps in our knowledge around our findings, and would benefit from further research about in dept exploration of how implementations The Three Line of Defense Cross Comparison Studies: Local Banking, National Banking and Foreign Banking.

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