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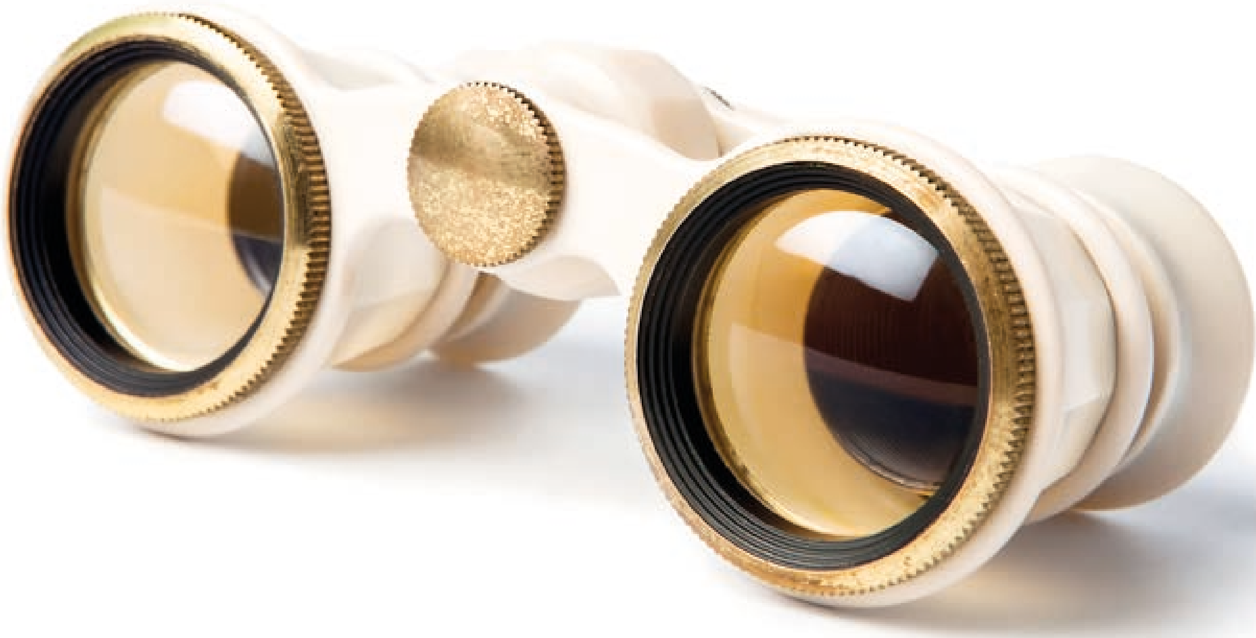
Looking ahead
2014 Hot topics for internal audit in financial services



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Key hot topics for 2014

The role of internal auditors in the financial services sector remains under scrutiny. Internal audit is expected to be highly influential and visible in providing value to their organisations. This year, a number of emerging topics have taken centre stage for the financial services industry. Internal audit functions will need to have considered their approach to these matters and to demonstrate coverage of a number of sensitive and sometimes ambiguous topics. Some of these were outlined in the Chartered Institute of Internal Auditors (CIIA) guidance for internal audit in financial services, released in July 2013.

1. Business leadership
- Governance
- Culture

2. Risk management
- Risk frameworks
- Risk appetite
- Risk data aggregation
- Model risk management
- Third-party risk management

3. Regulatory matters
- Conduct risk
- Financial crime
- Client assets
- Regulatory reporting

4. Capital and liquidity
- Liquidity management
- Risk weighted assets
- CRD IV

5. Trading
- Indices and benchmarks
- Unauthorised trading
- High frequency trading

6. IT
- Data analytics
- Payment services
- Cyber crime
- Data governance and quality

7. Accounting and tax
- Tax risk management
- Loan loss provisioning

1. Business leadership

Since the financial crisis, there has been intense scrutiny over the **governance of financial institutions** from regulators, investors and within organisations themselves. The recent publication of the CIIA guidance has clarified expectations that internal audit will assess governance and culture. For many internal audit functions this will be a new area within their audit universe, whilst for others now is the time to take stock and enhance their existing approach. The focus of governance audits is shifting from testing compliance with codes and regulations, to assessing the impact of governance activities in practice. There are a number of emerging trends and market focus areas in governance, for example increasing individual accountability and clarifying delegated authorities. Internal audit functions will need to ensure their approach and toolkit is kept up to date with emerging practice in order to effectively challenge the status quo and governance outcomes in their own organisations.

Culture has emerged as one of the fundamental issues under the microscope as policy makers, regulators and senior management in financial institutions seek to address what is perceived to be a root cause of the financial crisis. This is a complex topic and will pose many challenges as driving a real change in culture cannot be achieved swiftly, yet this is a vital part in restoring trust in the financial services industry. Organisations will need to move towards clearly stated values, with reinforcing incentive structures, delivering a culture that promotes the desired outcomes. This new focus on culture and behaviour in financial institutions demands that internal audit evaluate the "tone from the top" and begin to apply a culture lens within their audits.

2. Risk management

Risk appetite and its benefits, has come to the fore in financial services organisations with numerous case studies of failed firms whose ineffective risk appetite frameworks played a part in their downfall. Internal audit can assist the board in providing an independent assessment of the design and effectiveness of the risk appetite framework, its embeddedness and alignment with supervisory expectations. When firms are criticised for shortcomings in their risk governance and management an appetite framework is commonly prescribed as a cure by regulators. Internal audit should assess whether the risk appetite framework has been properly established, embedded and enforced.

Many organisations have recognised the need for good **operational risk management frameworks** with increasing demands from regulators and senior executives that controls are embedded in the business and delivering value. Internal audit have a role to play in ensuring operational risk management frameworks are not just focused on the framework design, but the clear governance, roles and responsibilities, training and awareness required for implementing and embedding it effectively. A well-defined and widely utilised operational risk appetite is a key tool for intrinsically aligning perceived 'front office' activities with the organisation's attitude to risk.

Organisations also continue to grapple with the challenge of concise but robust, high quality **risk data aggregation**, ensuring swift escalation of issues to the board, rebalancing the board agenda between strategic and regulatory matters and addressing the increasing demands on non-executive director time. There has been an increase on the quantity and quality of data required for regulatory and other external reporting purposes and internal audit should naturally evaluate the quality of this data and the overall data governance effectiveness.

Organisations often rely on outsourced parties to deliver support to critical functions of their business. Whilst these activities are outsourced, the responsibility for the activities still lies with the organisation and therefore requires robust oversight, where internal audit assess the effectiveness of firms' approach to third-party risk management and assurance frameworks over outsourced activities. Some firms have suffered reputational damage alongside significant outlays due to failures resulting from failures by third-party providers. As a result, it is imperative for organisations to have a comprehensive approach to **third-party risk management**.

Models have become an integral part of the operating environment for most financial institutions. However, models are only an estimate of reality. They carry varying degrees of uncertainty which increases with the level of sophistication and complexity of the model. Internal audit should have a framework for providing assurance over modelling governance and management, including having access to the quantitative skills for assessing models themselves. High profile cases of model failures have led some regulators to add a discretionary model risk charge to the capital requirements of most institutions. Owing to the reputational and financial implications associated with **model risk management** – identification, measurement and mitigation of model risk has gained considerable attention recently.

3. Regulatory matters

Financial services organisations are faced with more intensive scrutiny over **conduct risk**. For wholesale firms, regulators are challenging firms on who the likely end customer is for many of their products and expecting firms to be able to evidence their consideration of this. Internal audit is expected to challenge management on how they have taken consideration of the sophistication of the customer on each product, as well as how the customer has been put at the heart of their decisions. Many wholesale created products end up in retail customer portfolios and this is likely to remain an area of focus at both the product design stage and throughout its lifecycle. For retail firms, the focus should review whether products deliver what they are marketed as delivering. Regulators are also continuing to focus on firm's products and services, ensuring that they meet the long-term interests of both retail and wholesale customers taking into account the sophistication of that customer and ensuring full transparency for customers in the distribution chain in financial services organisations.

Regulators continue to focus on **financial crime**. The Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) are maintaining the forceful approach as noted by recent fines for anti-money laundering (AML) failings of a number of organisations. The failings have highlighted a number of weaknesses in firms, especially in relation to customer due diligence on high risk customers. With the impending introduction of the fourth EU Money Laundering Directive – internal audit is expected to have the necessary skills and experience to assess whether their organisation's policies, procedures and systems are geared to be enhanced to ensure adherence to more comprehensive AML requirements. Sanctions imposed by the UK, EU, US and United Nations are another area where financial institutions have been criticised for a lack of appropriate systems and controls.

Organisations are expected to have adequate arrangements over **client assets** in areas such as management processes, trust letters, treatment of collateral, completeness and accuracy of the client money calculations, oversight of outsourced providers and sufficient management information and reporting. Internal audit should be actively involved in providing assurance over these areas. Documentation over these areas is expected to be fully compliant with the CASS rules and there should be adequate second and third line of defence monitoring programmes, including internal audit, to validate the design and operation of controls as well as specialist skills to implement and monitor the CASS rules.

Financial institutions – and indeed internal audit functions themselves – are experiencing a step change in the quantity and granularity of **regulatory reporting** requirements, as a result of the implementation of Common Reporting Framework (COREP) and Financial Reporting (FINREP) in 2014, together with a range of other new reporting obligations and an increasing number of firm-specific and/or peer group data requests from regulators. Internal audit can assist senior management in demonstrating robust challenge and oversight over regulatory reporting, and satisfy themselves that a comprehensive control framework surrounding the new data requirements has been effectively implemented. The accuracy of capital, liquidity and other prudential returns is increasingly being challenged as a result of peer group review. The PRA and Bank of England have also announced their intention to seek to publish certain elements of firms' regulatory returns, resulting in greater external scrutiny.

4. Capital and liquidity

Robust funding strategies, daily **liquidity management** and forecasting remain a key business imperative. Many organisations continue to improve their internal stress testing and funding models and to undertake a more comprehensive assessment of the profitability, solvency and liquidity impact of combined enterprise-wide scenarios. As well as regular challenge around ALM/Treasury and Liquidity Risk Management systems, processes and controls, internal audit can play an important role in providing the independent challenge required by the regulations around Individual Liquidity Adequacy Assessment (ILAA) process and the extent to which the ILAA is demonstrably embedded in operational and strategic decision making.

Internal audit can play a key role as firms revisit the effectiveness of control frameworks in place to ensure completeness, accuracy and integrity of source data inputs and calculated **Risk-Weighted Assets** (RWA) outputs. The debate around the comparability and consistency of capital models continues, as both regulators and investors seek to better understand the reasons for variances in model results for similar asset portfolios. Against this backdrop of a series of initiatives aimed at enhancing transparency and disclosure within Pillar 3 and annual financial statements, combined with the qualitative model standards and review requirements in the EU Capital Requirements Regulation, internal audit is set to play a key role in ensuring the integrity of the RWA calculations is enhanced.

The publication in June 2013 of the final **CRD IV** package, which will implement the internationally agreed standards on capital and liquidity – Basel III – in the EU, marked the beginning of the long road to implementation and compliance. In addition to independent validation of controls underlying the production of key CRD IV calculations, such as Credit Risk Capital and Liquidity Coverage Ratio internal audit should also be involved in the review and challenge of CRD IV implementation plans, regulatory change management programmes, updated policies and procedures, and enhanced or amended calculation and reporting frameworks required to ensure compliance with the new minimum standards. The CRD IV package contains the EU's banking rules on capital, liquidity and leverage (applicable directly to institutions via the mandatory application of the Capital Requirements Regulation), together with specific mandates for the European Banking Authority to develop more detailed standards which will also form part of the Single Rulebook. National regulators are consulting on parts of the CRD IV package that allow for national discretion, as well as the CRD IV Directive which needs to be transposed in full.

5. Trading

The impact of the LIBOR scandal is still being felt by financial institutions and regulators, measurable in recent times through the implementation of regulation by the FCA (MAR 8.2) in April 2013, which makes the LIBOR submission process a Controlled Function along with specific requirements for internal and external audit functions. The spotlight is starting to shine on the processes and controls supporting other **indices, benchmarks, and wider price setting** processes that banks contribute to. Internal audit is required to conduct a periodic review of the governance and organisational arrangements on benchmarks as focus has turned on reviewing benchmark submission processes.

A significant **unauthorised trading** event could have a potentially terminal impact on many institutions. There is increased focus on developing and enhancing preventative controls and in particular, reinforcing the responsibility of the front office in establishing an appropriate culture and implementing an effective supervisory framework. Reviewing and challenging the effectiveness and completeness of unauthorised trading programmes is a focus area for many internal audit functions.

There should be clear accountability that exists to ensure supervisors are equipped with the appropriate resources and tools to perform their role effectively. Operational risk typically take a lead role in managing unauthorised trading risk, though designing and implementing control frameworks which effectively capture all risks across institutions can prove challenging.

Recent errors and failures in **high frequency trading** businesses have led to concerns around inadequate trade execution controls which can expose firms (and individuals) to significant losses and significant clampdown from regulators. The challenge to keep on top of these activities is ongoing, due to the dynamic nature of these activities and continued innovation in trading programs. It is critical for firms, with active involvement of internal audit, to constantly assess the control environment, to ensure the governance and controls structures are adequately mitigating the risks posed by high frequency trading.

6. IT

There is now an increased awareness of the power of using **data analytics** to support assurance activities, which has led to increased demand for enhanced analytics capability. While it is relatively simple to implement analytics tools, developing the skillsets to use such tools effectively, embedding their use into the audit plan and managing the target data is more challenging. Organisations are investing in this capability to help generate more sophisticated insights through audit work. For example, using data analytics to develop more complex hypotheses, joining related data sets which provide new perspectives on control effectiveness or more simply by enabling testing of larger samples.

Payment service providers have been under increased regulatory scrutiny in respect of both resilience and conduct (payment services regulation compliance). Complex change projects and changing expectations will pose a challenge for internal audit, with careful planning and appropriate subject matter expertise required for these areas – domain knowledge, complex shareholder groups and cross business impact. Further challenges will be introduced in 2014 with stringent account switching requirements going live since September 2013 and mobile payments in Spring 2014 against the backdrop of a thematic review by the FCA into mobile banking services. At a European level, the proposals for enhanced payment services directives were issued in July 2013 along with plans to cap credit and debit card interchange fees.

EU regulations are now in place which set an end date for the migration to SEPA compliance for all Euro payments in the region (February 2014 for Eurozone and October 2016 for the non-Eurozone countries). Other focus areas which internal audit could assist organisations in assessing impact include: the impact of payments on resolution and recovery plans, ring-fencing, intraday liquidity management, FATCA compliance, sanctions compliance and fraud prevention.

The digital revolution has changed the way we do business, but it has also created a sophisticated and complex set of security issues. Exposure to **cyber threats** increases as business embraces the digital world. As the threat of cyber attacks grows, regulatory demands increase and customer confidence can dwindle. Internal audit have a role to play in assuring organisations are geared to withstand attacks rather than simply trying to prevent them. Organisations are seeking to reduce the net impact and the time it takes to recover from an attack. While it may not be possible to be completely cyber-attack-proof, by carefully devising a cyber security defence and response strategy, organisations can build the next best thing: cyber resilience.

Data governance and quality are high priorities for organisations to tackle due to increasing regulatory attention and the business reliance on high quality data. Internal audit will naturally have assessed aspects of data control previously, for example security and access has been a focus of internal audit for many years but as businesses increase their focus on the customer, digital channels and explicit requirements in regulations, the need to assess the overall governance and quality of data is increasingly pertinent.

7. Accounting and taxation

The current tax landscape is more complex than ever with greater media and political interest in the policy debate. There has been widespread public criticism of perceived avoidance of taxes by some financial services organisations – on their own account, on behalf of their clients and in respect of their employees. The increased profile of tax and potential reputational ramifications mean that tax risk management has become a key area of focus for internal audit functions. Financial services organisations are seeking to ensure their approach to **tax risk management** is aligned with their broader commercial strategy and risk management approach and on providing internal and external assurance that their tax activity is appropriate. Internal audit functions face the challenge of assessing whether an organisation's tax governance structure, processes and controls for managing tax risk are embedded throughout the organisation in all business decisions and operations, as well as evaluating if compliance obligations are met across the range of taxes and tax reporting regimes that apply to financial services businesses. This is an area of focus for HMRC in recent years with the introduction of the risk assessment framework, the Senior Accounting Officer rules, and the consultation on strengthening the Code of Practice on Taxation for banks and building socities with potential for naming and shaming.

Accounting standard setting bodies have been working on a new **loan impairment** model for some time, addressing the criticisms that the current mixed measurement incurred loss model recognised provisions too little and too late. There remain some practical considerations that internal audit could assist with, around firms' transitional plans and assessing availability data to effectively roll this out. An agreement has been found to shift the principle to an expected loss model but the functioning of the precise model is somewhat trickier and this is not allayed by the growing uncertainty about the final outcome of the financial instruments accounting standard.

Contacts

Mark Fitzpatrick
Vice Chairman and Partner
020 7303 5167
mfitzpatrick@deloitte.co.uk

Paul Day
Partner, Banking and Capital Markets
020 7007 5064
pauday@deloitte.co.uk

Russell Davis
Partner, Banking and Capital Markets
020 7007 6755
rdavis@deloitte.co.uk

Ralph Daals
Director, Insurance
020 7303 8129
rdaals@deloitte.co.uk

Terri Fielding
Director, Investment Management and Private Equity
020 7303 8403
tfielding@deloitte.co.uk

Mike Sobers
Partner, Technology
020 7007 0483
msobers@deloitte.co.uk

Kevin Doherty
Partner, Technology
0141 304 5711
kedoherty@deloitte.co.uk

Jamie Young
Director, FS Regions
0113 292 1256
jayoung@deloitte.co.uk

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

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