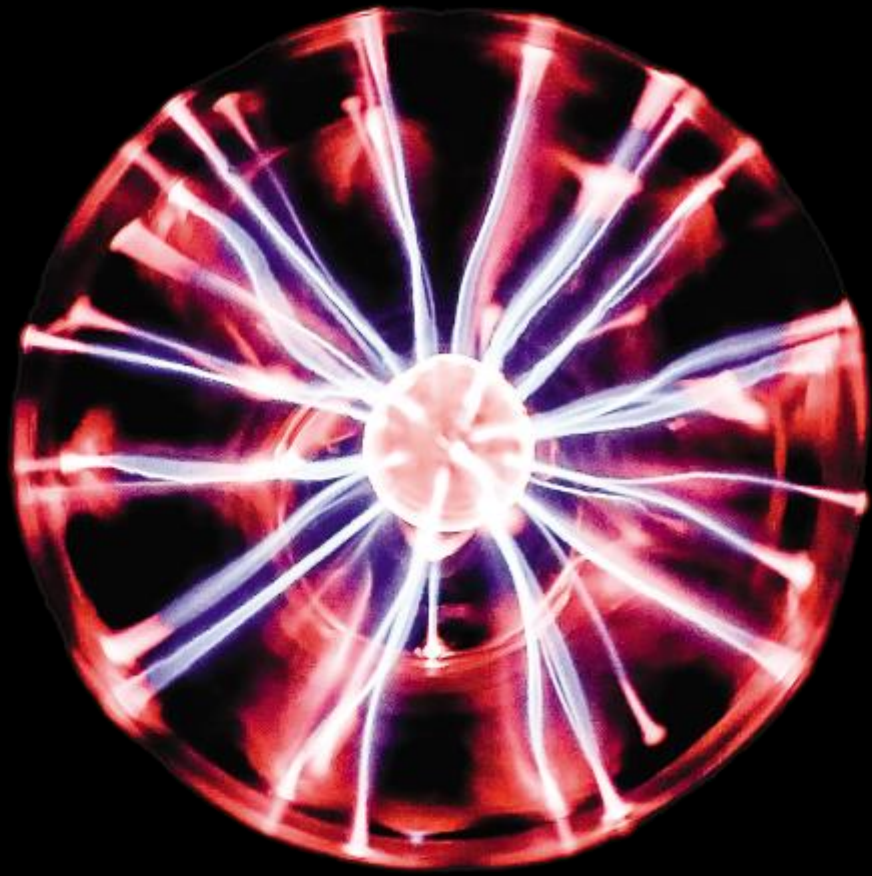
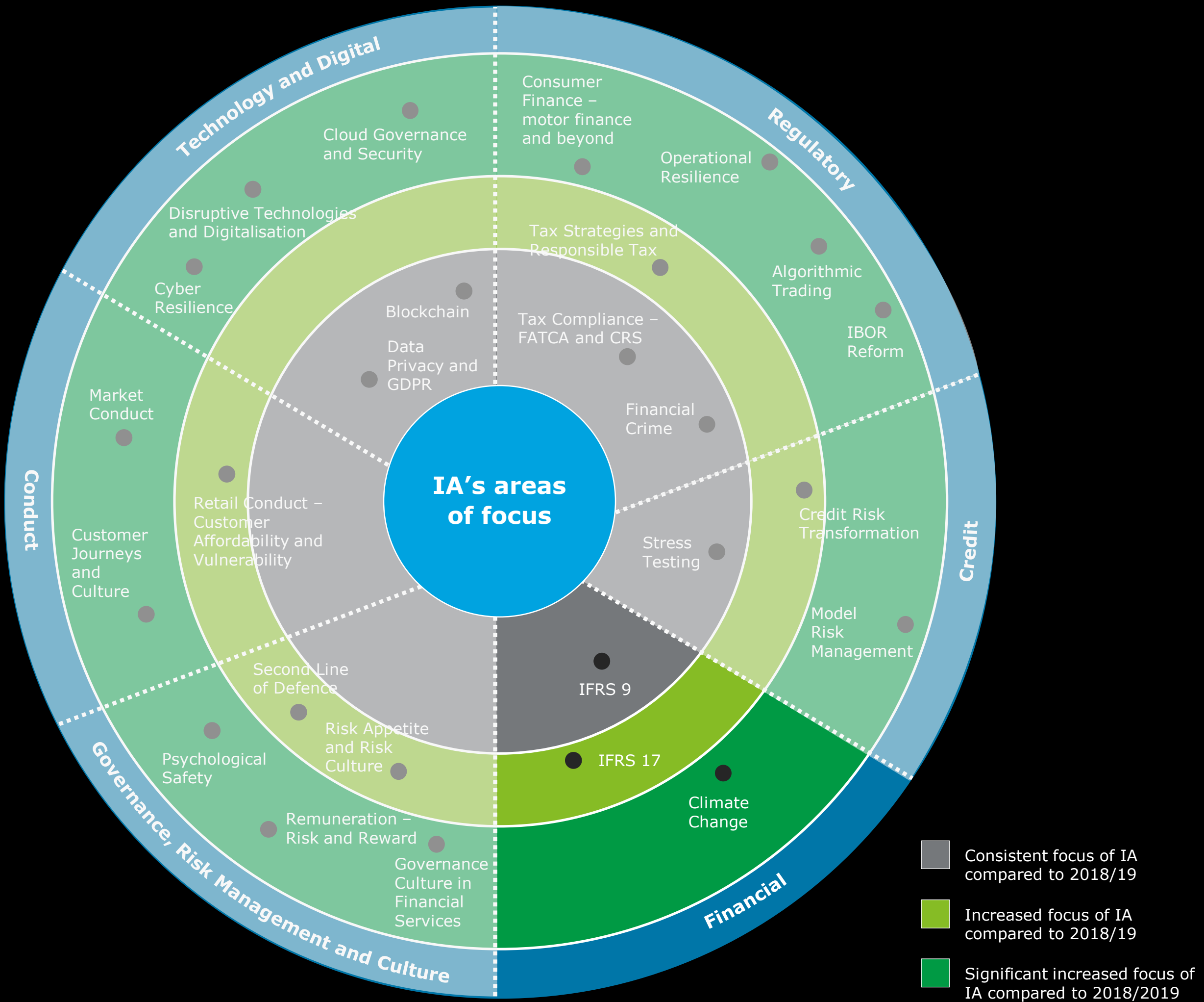


Financial Services Internal Audit

Planning Priorities 2020 – Financial Hot Topics

Introduction

IFRS 9, 15 and 16 have been implemented by firms, although firms continue to embed these new standards, and regulators are seeking greater harmony in firms' IFRS 9 approaches. The focus of regulators and firms has now expanded to IFRS 17, which represents a fundamental change to the way insurers report to the markets. Additionally, the financial sector has a key role to play in the transition to a lower-carbon economy, therefore Climate Change risks will affect firms and their Internal Audit plans going forward.



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Key Industry Icons

Banking and Capital Markets

Insurance

Investment and Private Equity

3.1 IFRS 17 and IFRS 9

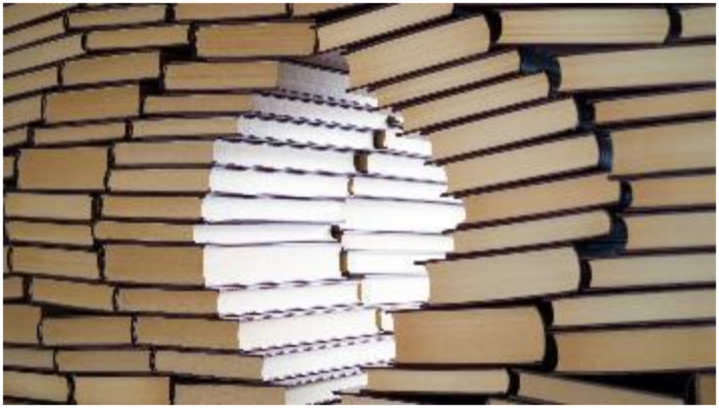
Why is it important?

IFRS 17 brings with it a fundamental change to the way insurers report to the markets. The standard will bring the industry closer to a 'margin' model of accounting showing insurance revenues and insurance service expenses separately, enabling the market to better compare insurers across industries. This reporting change will have an effect on all parts of an insurance business, and will introduce a need for new data, systems and ways of working.

The UK banking industry, in particular the large UK banks, invested significant resources to update financial and regulatory reporting for IFRS 9. The shift now moves to embedding the new standard, and implementing strategic solutions to replace tactical ones. Firms are also reflecting on regulatory feedback on their approaches, and in some cases considering changes to their IFRS 9 methodologies.

What's new?

- The International Accounting Standards Board (IASB) proposed a one-year deferral of the effective date of IFRS 17 to 1 January 2022. This includes a deferral of IFRS 9 to the same date for firms whose business is predominantly to issue insurance contracts.
- During 2019, the IASB has continued to consider a number of amendments to IFRS 17. Those which were approved for inclusion in the final standard will be formalised later in the year.
- Although according to a survey by Deloitte in partnership with the Economist Intelligence Unit the majority of insurers expected to achieve the original IFRS 17 timeline, the additional year has given organisations the chance to step back and assess their programmes.
- The PRA issued a Dear CFO letter on IFRS 9 in April 2019 to selected deposit-takers in scope for written reporting. There has been significant peer benchmarking on IFRS 9 approaches which is expected to result in a degree of convergence in approaches as IFRS 9 embeds.



What should Internal Audit be doing?

Area of focus	Description
IFRS 17 Readiness	Understand 'readiness' of the firm for the new standards from a project governance, technology and resourcing perspective, including second-order impacts such as Investor Relations and Reward.
IFRS 17 Audit planning	Ensure a holistic risk-based audit plan is prepared which covers the length of the implementation period of the standards and covers all significant areas, whilst including time for remediation findings where necessary. Internal Audit should be prepared for slippages in the implementation of elements of IFRS 17 projects, which may also lead to shifts in the timing of audit delivery.
IFRS 17 technology solutions	Where firms are well progressed in their IFRS 17 projects (e.g. are at the stage of carrying out testing of new systems or tools) this presents an opportunity for Internal Audit to provide early assurance, particularly if the system is to be rolled out in other locations. Internal Audit should consider involvement of SMEs during the development phase of technologies to advise on how the firm can build in assurance 'by design'.
Embedding IFRS 9	Review of governance over models and methodology refinements and ongoing operational effectiveness of controls. Review sensitivity disclosures, significant increases in credit risk, behavioural lives, post model adjustments and multiple economic scenarios Review the firm's broader consideration of feedback from the PRA in their Dear CFO letter issued in April 2019 (relevant to both firms in scope for written reporting and other banking institutions).

3.1 IFRS 17 and IFRS 9

Are there any potential challenges?

Challenge	Description
Evolving approach	Internal Audit will need to adapt their approach over the lifetime of the implementation of IFRS 17 and then move towards a BAU methodology while still challenging the business appropriately from a technical perspective. Likewise, Internal Audit should remain alert to evolving regulatory views and changes in the economic environment when considering the adequacy of IFRS 9 approaches.
Talent	Firms will need to ensure that audits are resourced with the necessary technical specialists in the areas of complex accounting and valuation. Teams working to implement IFRS 17 in the business can consist of up to 90% actuaries. This can present a challenge for some Internal Audit functions where it is not possible to source in-house actuarial knowledge from a resource who is sufficiently independent of the IFRS 17 project.
Collaboration	Interaction with external audit and other key stakeholders is important to ensure that the work performed by Internal Audit adds value.

What Internal Audit skills are required?

- Technical accounting skills, a working knowledge of the standards and an understanding of how the business is implementing them.
- Depending on the element of IFRS 17 and 9 being examined, specialist input may also be required from areas as broad as Finance, Change Management, Technology, Legal, Human Resources and Risk.

What's next?

- Now that IFRS 17 is approaching its final form and implementation projects gain momentum, firms will see details of IFRS 17 as projects emerge which may lead audit functions to reassess their areas of focus.
- Some Internal Audit teams are considering enhancing their original IFRS 17 risk assessment by defining 'triggers' for re-evaluation of areas previously concluded to be lower in risk if, for example, a project milestone or a system implementation is missed.
- We expect the PRA and international regulators to continue to seek further harmonisation in firms' approaches to IFRS 9.
- The Disclosures about expected credit losses (DECL) task force is expected to publish recommendations on IFRS 9 disclosures during Q4 2019.

Find out more

- https://blogs.deloitte.co.uk/financialservices/2019/02/ifrs-17-.html
- https://www2.deloitte.com/uk/en/pages/financial-services/articles/after-the-first-year-of-ifrs-9.html

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3.2 Climate Change

Why is it important?

Climate change and the resulting catastrophic effects on our environment have never been more apparent. Warmer temperatures, accelerated rises in sea levels and extreme weather events are visible around the world. As government bodies have begun to take action through legal frameworks and global initiatives such as the Paris agreement, accredited by 185 parties, there is now increasing pressure on the financial sector to recognise its role in moving to a lower-carbon economy and managing the associated transitional and physical risks.

What's new?

- The FCA and the PRA have released discussion papers to consult on the approach for managing climate-related risks impacting the financial industry, with the FCA publication focusing in particular on the importance of green finance, an important element of transitioning to a lower-carbon economy.
- The FCA and the PRA launched the Climate Financial Risk Forum (CFRF). The forum brings together senior representatives from across the UK financial sector, with an objective to enhance responses to the financial risks resulting from climate change.
- The Network for Greening the Financial System (NGFS), a network of 34 central banks and supervisors across five continents, published their first comprehensive report outlining the necessary actions to be implemented in order to facilitate the role of the financial sector in achieving the objectives of the 2015 Paris Agreement.
- In conjunction with the release of the first NGFS report, the Bank of England published an open letter urging financial regulators around the globe to perform climate change stress tests.
- The European Commission published guidelines on the reporting of corporate climate-related information, as part of its action plan on sustainable finance.
- The UK became the first major economy in the world to pass laws to eradicate its contribution to global warming by 2050. The target will require the UK to bring all greenhouse gas emissions to net zero by 2050.

What should Internal Audit be doing?

Area of focus	Description
Risk Management	Review whether the firm has fully embedded their approach to identifying, evaluating, monitoring and reporting of risks arising from climate change into their existing risk management framework.
Governance	Consider whether the firm's governance framework facilitates sufficient oversight of the firm's risk appetite, in particular, board-level engagement and well-defined roles and responsibilities for managing climate-related risks.
Scenario Analysis	Assess the design of scenario analysis performed to support the risk identification process and to assess the impact of climate-related financial risk. Consideration should be given to the range of scenarios ensuring adequate coverage of both risks arising from the transition to a lower-carbon economy and the associated physical risks.
Collaboration/ Strategy	Challenge management on the level of collaboration within client institutions, encouraging knowledge sharing with each other and with wider stakeholders to improve their understanding of how climate-related issues translate into risks and opportunities.
Disclosures	Assess the firm's commitment to disclosing the financial impact of climate change, recognising that failure to do so may impact investor decisions.

3.2 Climate Change

Are there any potential challenges?

Challenge	Description
Breadth and Magnitude	Climate-related risks will affect multiple business lines and geographies. The correlation may be non-linear and the full impact may therefore be more widespread and diverse than other structural changes.
Uncertainty	Whilst climate science identifies that action to address climate change is needed now, today's macroeconomic models are unable to accurately predict the full extent of the financial impact of climate change. Uncertainty over which time horizons' risks will be realised is apparent and the appropriateness of using past data to predict future risks must be challenged.
Resourcing	Ensuring that Internal Audit teams are sufficiently resourced with specialists and SME's will be critical to facilitate effective execution of such specialised audits.
Political Influence	Whilst legal frameworks have already begun to change to support the transition to a lower carbon economy, political will may be subject to change in the current environment. The uncertainty of the political landscape does not allow for the UK's stance on climate change and related impact on financial institutions to be fully determined.

What Internal Audit skills are required?

- Specialist knowledge of regulatory and legal requirements across a range of jurisdictions to support effective design assessments of related controls.
- Understanding the varying levels of climate-related physical and transitional risks of which each firm is exposed and how these manifest within each business line.
- Ability to manage and engage with key stakeholders to understand and challenge roles and responsibilities in respect of managing climate-related risk.

What's next?

- Firms should ensure they demonstrate sufficient continued engagement with regulatory bodies, industry networks and read related publications to advance the development of their approach to managing climate-related risks.
- As the demand for green finance increases, so does the importance of green taxonomy, related green disclosures and green performance management. The FCA recognises its role in providing guidelines and structure to ensure fairness and consumer protection and further changes in this space can therefore be anticipated.
- The FCA has set a 'Green fintech challenge' calling for the development of innovative green products in the market hoping to create solutions in areas such as 'supporting capital flows/investment towards green products and services' and 'driving efficiency in the issuance, distribution or adoption of green products.'
- To help firms translate the effects of climate change into tangible measures, Deloitte have partnered with the ICAEW to develop an online learning tool with the objective of helping companies place their climate change response as a key element of their business model.
- The impact of climate change on the financial sector remains a hot topic and firms should recognise the need to respond accordingly.

Find out more

- http://www.deloitte.co.uk/climatechange/

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