Internal Audit insights – thought leadership for Internal Auditors in banking and capital markets

September 2014

Building a better working world


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SDB

Contents

Introduction

The Internal Audit (IA) function that successfully adapts to today's rapidly changing world will become an effective third line of defence.

Today, change is coming faster than ever before – and there's more of it. The sheer velocity of change has altered the business environment and rearranged the landscape. While organizations around the world are striving to get ahead of the curve; they're struggling to keep up – and often not succeeding.

With technology and the world economy changing at an accelerating pace, organizations need to adapt swiftly and efficiently. Many businesses face increasing levels of risk due to expanding operations in emerging markets and developing countries. Meanwhile, regulatory requirements are escalating and the intertwined forces of globalization and advances in technology are creating new opportunities, but also new risks.

All these forces have had a profound impact on the Internal Audit (IA) function. IA must balance priorities and resources to help the organization address the risks it faces today and anticipate emerging risks. The challenge is significant, and so is the payoff – the IA function that successfully adapts to today's rapidly changing world will become an effective third line of defence providing robust, independent assurance over the managing of risks.

To start, the IA function must maintain a laser focus on basic and core activities, but it must also be ready to take on more of an advisory role. And it must be able to 'look around the corner' to see tomorrow's risks today.

In the pages that follow, we'll discuss some of the industry trends, Internal Audit thought leadership and emerging risks that organizations are most likely to face, including those that could impact existing processes – and what your IA function can do to address those risks.

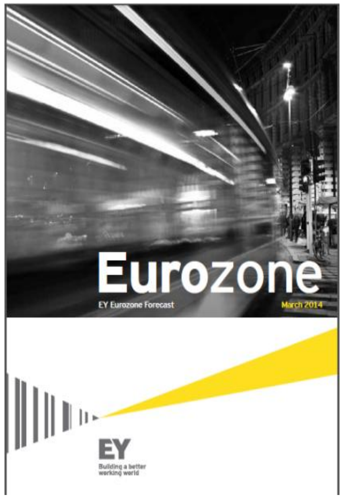

HSBC

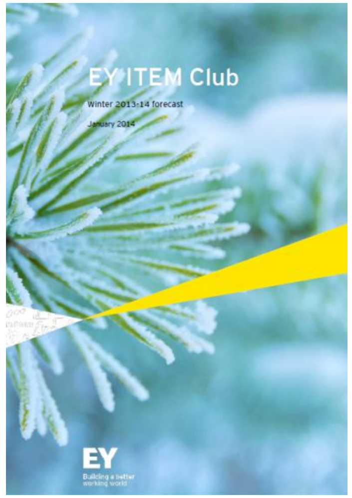
Industry trends and news

Eurozone Forecast: June 2014
"The Eurozone has sustained its gradual recovery. But growth will not be strong enough to erode the spare capacity in the economy. This suggests that inflation will remain very low and a period of deflation cannot be ruled out."
Mark Otty, Area Managing Partner, Europe, Middle East, India and Africa. Click here to read the full article…

Eurozone Forecast: March 2014
"Despite the recession coming to an end in mid-2013, the Eurozone economy contracted for the year as a whole. A return to growth is expected in 2014. But risks from deflation, divergence and unemployment mean optimism must be met with caution."
Mark Otty, Area Managing Partner, Europe, Middle East, India and Africa. Click here to read the full article…

EY ITEM Club Winter 2013-2014 forecast – January 2014
The economy is strengthening and we expect GDP to grow by 2.7% this year after 1.9% in 2013.
The rapid expansion of employment has boosted consumer confidence and families that have been putting money away for a rainy day are now happy to spend this. Click here to read the full article…





Industry trends and news (cont'd)

Business Banking: Redesigning the front office – July 2014

In an increasingly competitive environment, our new report, helps banks realize the significant opportunities that the small and medium sized enterprise segment presents by identifying four key elements that can help banks better meet the evolving needs of SME customers. Click here to read the full article…

Risk Culture: Meeting regulatory expectations and accessing culture – June 2014

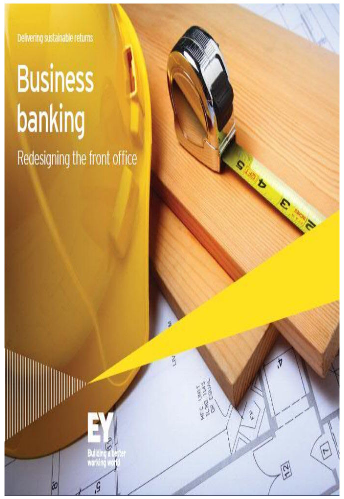
"Culture counts. A sound risk culture is likely to lead to the right risk outcomes, while a weak risk culture may promote the wrong outcomes – for customers and/or the financial institution itself."

Click here to read the full article…

The Journal of Financial Perspectives – July 2014

This paper discusses the unintended consequences of regulatory oversight and control through looking at the banking and asset/alternative funds industries. These consequences are the result of financial managers, and their organizations, facing increased regulatory induced business dilemmas.

Click here to read the full article…

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Industry trends and news (cont'd)

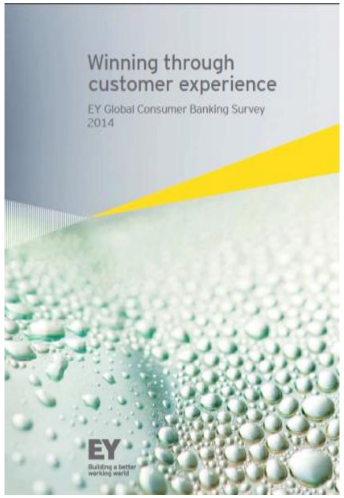
Winning through customer experience EY Global Consumer Banking Survey 2014
Confidence in the banking industry is rising, and trust in customers' own financial services providers is high. But customers are moving, with unprecedented access to competing banks and to new types of financial service providers. Banks must earn the highest levels of trust in order to create genuine loyalty. Click here to read the full article…

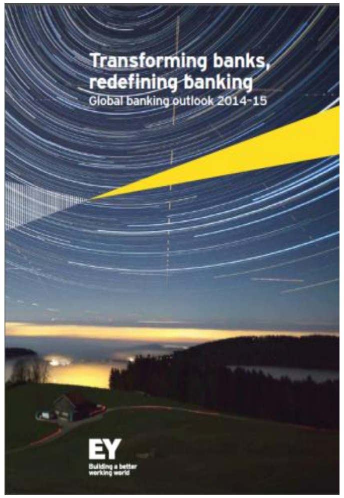
Transforming banks, redefining banking – Global banking outlook 2014-2015

The more things change, the more they stay the same. That may be true in some aspects of life, but not in the banking industry. At a global level, the scale of change in the industry since 2008 has been unprecedented. The industry is anything but the same. Click here to read the full article…

The Banker special report in association with EY, Transforming the Bank – January 2014

There's a lot of detail to be worked through before we can say that we've got close to solving the issue of too big to fail. Click here to read the full article…



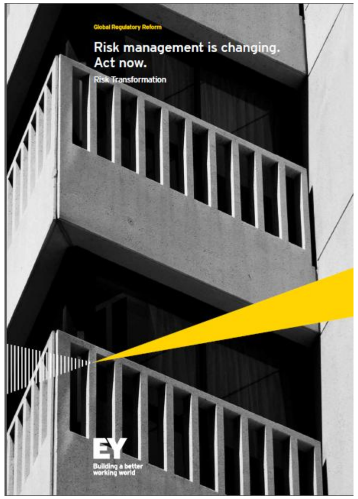


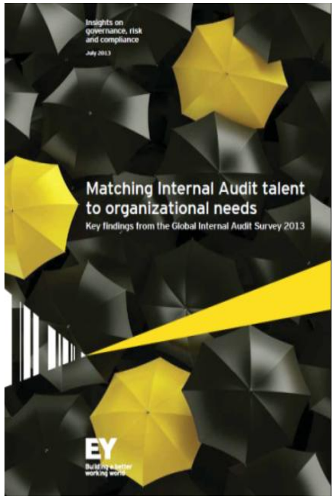
Internal Audit thought leadership

Risk management is changing. Act now. Risk transformation– September 2014
‘It is time for transformational change and there are difficult choices to be made. Banks that dare will win’. Risk management cannot operate as it is. Radical changes are needed to ensure efficiency and reduce costs. Regulators are demanding a strategy and roadmap to ensure changes are delivered. Available soon on www.ey.com ...

Improve your business performance. Transform your governance, risk and compliance program. – August 2014
Rapidly changing technological innovations have significantly changed the risk landscape. Companies lagging behind the innovation curve, increase
their vulnerability to these proliferating risks.
Click here to read the full article…

Matching Internal Audit talent to organizational needs
Key findings from the Global Internal Audit Survey 2013 – July 2013
With evolving technology and expansion into emerging markets, business environments are changing quickly. Internal Audit needs to address changing compliance requirements and to effectively serve as a strategic advisor. Click here to read the full article…



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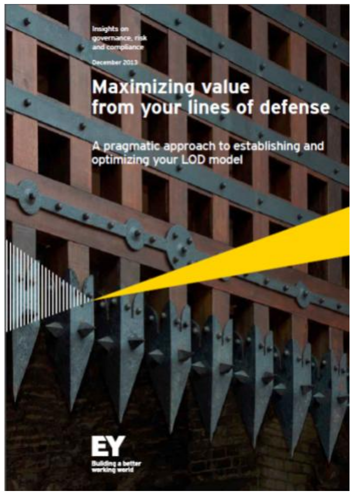
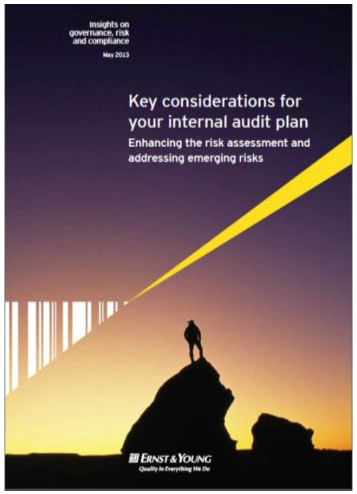
Internal Audit thought leadership (cont'd)

Expecting more from risk management. Drive business results through harnessing uncertainty – May 2014
In an increasingly complex world, organizations need to continually advance their risk management practices, building on the strong foundation of compliance into an expanded focus on risk factors that impact strategy and operational performance. Click here to read the full article…

Maximizing value from your lines of defense. A pragmatic approach to establishing and optimizing your LOD model – December 2013
The Institute of Internal Auditors (IIA) has stated that the 'Three Lines of Defense' model provides a simple and effective way to enhance communications on risk management by clarifying roles and duties. Click here to read the full article…

Key considerations for your Internal Audit plan. Enhancing the risk assessment and addressing emerging risks – May 2013
While there are often a number of 'non-negotiable' activities that Internal Audit functions must support (SOX and external auditor assistance), they also have the opportunity to deliver increased risk coverage and measurable value to the business. Click here to read the full article…





Risk culture

Business failures, customer detriment and stakeholders' expectations are resulting in increasingly interventionist regulators and a shift of debate from 'risk culture can't be measured' to 'we need to demonstrate what we're doing about strengthening risk culture by reinforcing the right attitudes and behaviours.' Internal Audit must have the approach and skills to assess the adequacy and effectiveness of the firm's risk and control culture, and report its findings to the Executive and the Board. The Chartered Institute of Internal Auditors has included the review of risk culture as a requirement in their new code for UK Internal Auditors in financial services.

Regulatory fines, public settlements imposed have significantly increased in recent years (e.g., $2.6bn to date from Libor scandal, $9bn regarding alleged mortgage foreclosure wrongdoing, $20bn in product mis-selling …), in many cases highlighting bad behaviours and weak culture.

Company directors and regulators are increasingly focused on assessing, and being seen to assess, risk culture. In late 2013, the Financial Stability Board (FSB) set out recommendations for how to enhance the effectiveness of supervision on risk culture.

Strong risk culture balances stakeholder needs, making it an organisation where:

- People want to work
- Customers are loyal
- Regulators have confidence
- Investors want to invest

The Financial Conduct Authority (FCA) has focused on firms' own understanding, articulation and monitoring of risk culture as a critical measure of management effectiveness.

Internal Audit consideration

The challenge for audit functions is how to establish an approach that allows Internal Audit to systematically assess the organisation's culture. Leading functions are building cultural considerations into their risk assessment and audit planning processes, to target the higher risk areas of the organisation, in addition to designing audit testing techniques.

Internal Audit must identify an approach to make the intangible tangible by using a model of risk culture which is evidence-based, in addition to conducting surveys and interviews.

Leveraging our ICOM model© for auditing culture, EY is working with a range of organisations to help them build an approach to auditing culture that works for them. For more information around auditing risk culture, please contact Clive Cain email: ccain@uk.ey.com and Gayle Sparkes email: gsparkes@uk.ey.com.

Risk appetite

Five years on from the crisis, Basel III has imposed higher capital standards on banks and regulators are demanding clearly articulated risk appetite frameworks. These should demonstrate closer alignment to the business planning process and more explicit links to capital resources of the firm on a forward looking basis. Risk appetite is an essential part of the risk management framework. Firms continue to address the challenge of embedding the risk appetite down through the lower levels of the organization, as well as enhancing underlying risk capabilities such as stress testing that underpin risk appetite.

The Financial Stability Board (FSB) recently issued a paper which establishes the key principles for Banks in developing their Risk Appetite Frameworks (RAF). This provides banks, and regulators, with guidance on the core components of an effective RAF, as well as providing clarity and consistency over the language and definitions used in risk appetite. The FSB paper makes clear the expectations that regulators should have when assessing a bank's approach to risk appetite. These include:

- An effective RAF that encompasses both a 'top-down' and bottom-up approach to risk appetite, which is aligned to the strategic planning and decision-making processes of the Bank
- Clearly articulated risk appetite statements, comprised of both quantitative and qualitative measures and, which are capable of being implemented by the business
- Risk appetite statements which ensure that risk levels remains within the Bank's risk capacity.
- Risk limits which allocate the aggregate risk appetite across the Bank's business units and legal entities

It is the responsibility of the Board to assure that the bank has an effective RAF, and it is the responsibility of the CEO, CFO and CRO to develop and implement it.

Internal Audit consideration

Under the FSB guidance, the Board is responsible for ensuring the RAF is effective and is aligned with regulatory expectations. In many organisations, it will be Internal Audit who will be expected to provide the Board with regular independent assessment of the RAF on an institution-wide basis, and on individual business lines and legal entities. The main challenge for Internal Audit will be in ensuring they have sufficient manpower and expertise to meet the Board's expectations in this area, whilst at the same time delivering BAU activities in the audit plan.

Management will need to ensure they have access to technical risk specialists who understand the Regulator's expectations, and who are able to objectively assess the quality and use of the RAF within the context of a bank's strategic business planning, decision-making and risk culture.

EY has worked with a wide range of banks to help design and implement their risk appetite frameworks, as well as assisting boards in undertaking independent effectiveness assessments. For further information please contact David Brown email: dbrown1@uk.ey.com and Cristiano Sechi email: csechi@uk.ey.com

Financial crime challenge

In response to ever-evolving threats and ways to launder the illicit proceeds of crime, the financial services sector is making considerable investments in financial crime prevention. A recent EY survey revealed that 68% of 230 financial crime professionals agreed that attention towards financial crime prevention at senior level has increased noticeably whilst 77% mentioned that Anti-Money laundering is a key priority for senior management. Other main issues were that systems and controls are not flexible enough to keep up with regulatory changes, there is a lack of skilled professionals and that regulators do not provide detailed guidance and support regarding the implementation of new requirements.

Regulatory pressure has become a main driver of change for companies. EY's recent experiences have given us insight into the following key focus areas for regulators:

- Governance (policies and procedures, roles and responsibilities, management information, record keeping, escalation and approval process, training and awareness, enterprise-wide risk assessment, staff performance).
- Customer due diligence (customer and related party identification, customer business profile, source of funds and wealth)
- On-going customer monitoring (transaction monitoring, periodic customer review, trigger-driven review, data management).
- Financial crime intelligence (previous intelligence analysis, trends and law enforcement case analysis, information from legal and regulatory updates, research and knowledge sharing).
- Investigation, escalation and reporting (internal and external reporting of breaches and blocked assets, investigation management).
- Monitor and improve effectiveness of controls (compliance and risk monitoring of process and controls, periodic customer review, trigger-driven customer review, Internal Audit).

Internal Audit consideration

The demand from Regulatory presents auditors with significant challenges to address. Recently, we have helped a number of institutions to address the following issues:

- Governance and policy – assisted in enhancing an approach to KYC and client on-boarding across all business lines of a global bank; developed a risk methodology and global policy standards.
- Risk assessment – delivered a global sanctions risk assessment for one of the world's largest financial institutions, providing coverage of 70 countries within extremely tight timeframes through a global centralised programme team and our global AML and Sanctions network.
- Remediation – completed the investigation of backlog and remediation of AML/KYC transaction monitoring alerts for a major international investment bank.

By leveraging our experience across financial services, we are able to provide clients with a view of market practices. We support our clients in many ways, for further information please contact Avisha Patel email: apatel8@uk.ey.com.

Technology risk

Technology Risk management has become a Board level imperative particularly in the guise of Cyber Crime and IT resiliency. We have seen IT issues impact shareholder value, tarnish brands and bring exposure to litigation. Internal Audit must continually develop its understanding, skills and experience of evolving technologies and risks but faces a significant challenge in finding and retaining the required combination of technical and audit skills.

In addition to the internal drivers for improved IT risk management, this is an area of keen interest for regulators and others. As EY's Global Banking Outlook 2013-2014 noted the 'multitude of new regulations is already placing considerable stress on banks' data and reporting platforms. cyber security is also an ever-more prominent issue, particularly with outdated systems and data storage requirements'.

Internal Audit consideration

Heads of IT Audit are increasingly challenged to deliver broader, deeper and cost effective assurance. To this end we are seeing:

- Keen interest in adopting and embedding data analytics
- Consideration of innovative resourcing models including 'Centres of Excellence' for specific IT skills
- Heightened co-source demand for specialist IT and data auditors
- Greater focus on IT risk assessment and aligning technical audits to the 'risks that matter'
- Increase in integrated auditing with IT and business controls addressed in combined 'end to end' audits

Internal Audit consideration

Potential areas for IT Internal Audit focus include:

- Cyber security governance, programmes and controls
- IT resiliency
- Insider threats (e.g., unauthorised access)
- IT risk management and governance, including third parties
- Crisis and incident response
- Data governance
- Intra group IT service provision
- Physical security (e.g., branches, ATMs)
- 'Cloud' governance, security and service provision
- Digital strategy and associated risks

59%

of organisations cite an increase in external threats

31%

of respondents report an increase in security incidents

For more information around auditing Technology Risk please contact Neil Robertson email: nrobertson@uk.ey.com.

[1] EY Global Information Security Survey 2013.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Recovery and Resolution Plan (RRP)

Regulators are requiring global systemically important financial institutions (G-SIFIs) and large firms to prepare RRPs which they should have in place in advance of a crisis to protect core and systemically important businesses and reduce the systemic risk of individual firms' failure, facilitate private sector recovery and allow for efficient resolution. Recovery plans often linked to existing enterprise stress testing and contingency funding planning, identification of options to survive periods of stress whereas resolution plans focus on information needed at time of resolution to allow for an orderly, least-cost and timely wind-down.

Key focus:

- Identification of actions that can be taken to aid recovery and information that is necessary to support efficient resolution
- Identification of institutions' economic functions that are systemically important and/or core to their business operation that should be protected

Key updates from PRA's December 2013 Policy Statement:

Recovery:

- Firms should identify actions that should be taken to improve the credibility and effectiveness of their recovery plan

Resolution:

- The firm should provide basic information on its financial, legal and operational structure, and economic functions in Phase 1
- Further information necessary to support authorities' preferred resolution plan strategy and preparation of resolution plan is requested in Phase 2
- In a change to the previous single set of guidance approach firms will now be asked for specific information relevant to their scale of operations and chosen resolution strategy (e.g., SPE or MPE)

Internal Audit consideration

As part of governance arrangements in the PRA's December 2013 Policy Statement, the firm's Audit Committee must periodically review the recovery plan and resolution pack.

The Internal Audit plays a central role in conducting this review and submitting the findings to Audit Committee.

Key IA challenges may be interpretation of RRP regulations and cross-border regulatory expectations.

Our skills:

- Integrated team (Finance, Regulatory Reporting, Risk and IT) to assess the IA impact and plan the audit scope)
- Involve overseas audit teams for cross-border audit
- Training on the rules

Our experience:

Utilising our RRP IA approach, EY is working with number of G-SIFIs to review their RRP for adequacy and compliance with regulations. For further information please contact Tareq Tarazi email: ttarazi@uk.ey.com.

Conduct risk

In the aftermath of the recent financial crisis, conduct risk has earned a prominent place in the evolving regulatory agenda. Placing customers' and the markets interest at the centre of strategic and operational decision making is a key step in promoting market confidence and stability in the financial services industry.

In the UK, the FCA has referred to conduct risk in the context of *'consumer detriment arising from the wrong products ending up in the wrong hands, and the detriment to society of people not being able to get access to the right products'*

FCA Risk Outlook 2013

What does this mean for firms?

- **A widening scope**
  "The new voice is about conduct. Not just a conduct toward the man in the street, but also conduct for major players in the system – for banks, investors of all kinds, people who borrow, people needing insurance and conduct in the dealing rooms of the City."

  (Martin Wheatley, The fairness challenge, October 2013)
- **Pre-empt rather then react**
  "We have developed a new and more focused supervisory model, this entails moving from a reactive approach to a pre-emptive and judgement-based approach"

  (Martin Wheatley, Looking ahead to 2014, December 2013)
- **Conduct at the heart of your business**
  "Firms should look at their business model, strategy and structure to critically assess whether any of the drivers and forward looking risks apply to their own business and how they may play a role in dealing with these in a way that is fair to consumers, promotes effective competition and market integrity"

  (FCA Risk Outlook, March 2013)

The CIIA guidance 'Effective Internal Audit in the Financial Services Sector, published in July 2013 stated that, Internal Audit should include within its scope:

Risks of poor customer treatment, giving rise to conduct or reputational risk

- Internal Audit should evaluate whether the organisation is **acting with integrity in its dealings with customers** and in its **interaction with relevant markets.** Internal Audit should evaluate whether Business and Risk Management are adequately **designing and controlling products, services and supporting processes** in line with customer **interests and conduct regulation.** (Principle 6e)

Potential IA coverage areas, should include customer and market conduct areas such as:

- Conduct risk framework
- Sales of general insurance/add on products
- Packaged accounts and Packaged Retail Investment Products
- Product governance
- Mortgage arrears and forbearance

EY works in the forefront of the changing Regulatory Framework. For further information please contact Harjeet Powar email: hpowar@uk.ey.com.


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Conflicts of interest

History of finance is inundated with examples of poor management of conflicts of interest (COI). PPI. SWAP miss-selling, Banker's bonuses, LIBOR and the ongoing investigation in FX to name but a few cases in the last few years COI situations arise where a customer's or potential customer's interest conflicts with that of another customer/other customers and/or the firm's interests. As a result there is a material risk of damage to the interests of a Client or the Firm. The FCA has highlighted COI as one of its key focus in the year and thematic reviews of selected banks are expected.

The importance with which the UK's FCA place on COI's within Wholesale Banking is apparent within its 'Risk Outlook 2013':

'Poor conduct of risk in wholesale markets poses a risk to our objectives through the way in which it threatens the soundness, stability and resilience of financial markets and transparency of price formation process. It often involves exploitation of differences in expertise or market power, which undermines trust in the integrity of markets.

The importance of information asymmetries as a driver of wholesale conduct risk is reflected in the extent to which structural conflicts of interest are often deeply embedded in wholesale business models. For example, consumers' interests can be compromised where firms exploit knowledge of a client's trading intentions to deal ahead (front running a client order and make a proprietary trading profit) or when firms or individuals are incentivised to carry out transactions that are not in the consumer's (client's) best interests, e.g., payment for order flow'.

Internal Audit consideration

The challenge for most organisations is to identify and manage conflicts in four key areas:

- Enterprise-level frameworks to identify and manage COI;
- COI in new products;
- Compensation and remuneration
- Outside business interests, personal trading, gifts and expenses, staff hiring and vendor selection, etc.

Internal Audit plays a critical role in assessing the organisation's conflicts of interest framework which mean a combination of assessing underlying ethics culture, organisational structures, policies, processes and incentive structures that in totality shape a firms management of COI.

EY has assisted Financial Services in building a COI assessment framework including education workshops, questionnaires and risk matrices that pre-empts the FCA's thematic review in COI. For further information please contact Jonathan Fisher email: jfisher2@uk.ey.com and Ee Lin Song email: esong@uk.ey.com.

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