



Brexit: considerations for your Internal Audit operating model

Next steps

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The UK financial services (FS) sector has been facing unprecedented uncertainty after the British people voted to leave the European Union (EU) on the 23 June 2016.

Whilst the final terms of exiting the EU remain uncertain, the Prime Minister has provided some clarification on the specific objectives that the UK Government is hoping to achieve through its negotiations.

To help Internal Audit (IA) functions through the challenges and uncertainty ahead, EY is producing a series of articles on how Brexit will impact the IA operating model and what this means for IA. In this first issue, we break down some of the implications for financial services firms and outline some of the considerations for your IA operating model.

Implications for financial services

The long-term impact on the FS sector will depend on the exit terms to be agreed over the course of the negotiations in the next few years.

However, it is clear that the current FS industry's operating model and governance will be significantly affected.

On 17 January 2017, the UK Prime Minister, Theresa May outlined twelve negotiation objectives which will define the UK's Brexit strategy when entering talks with the EU. Whilst not all twelve objectives directly relate to FS, there is a clearer vision from the UK Government around the UK-EU deal, and how it could impact FS. Some of the key messages from the speech include the Government's desire to leave the Single Market, and for the UK to control its own borders, whilst remaining open to international talent.

Access to Single Markets

The Prime Minister expressed the objective to leave the Single Market and its intention to seek a "bold and ambitious" trade agreement with the EU to replace it. Regulations which are currently governing UK-based FIs may change following these treaty negotiations, especially regarding passporting rules and the degree of reciprocal recognition of regulatory equivalence.

Passporting

Allows for firms that are authorized to provide financial services in one EU jurisdiction to provide them in another, without the need for authorization in the second jurisdiction. A firm authorized in a European Economic Area (EEA)¹ state has the right of establishment of a presence (branch and agents), or the right in providing cross-border services.

Passporting can take place in relation to the following eight current Single Market directives:

- ▶ Capital Requirements Directive (2013/36/EU)
- ▶ Solvency II Directive (2009/138/EC)
- ▶ Insurance Mediation Directive (2002/92/EC)
- ▶ Markets in Financial Instruments Directive (2004/39/EC)
- ▶ Undertaking Collective Investment Scheme Directive (85/611/EC)
- ▶ Payment Service Directive (2007/64/EC)
- ▶ Second Electronic Money Directive (2009/110/EC)
- ▶ Alternative Investment Fund Managers Directive (2011/61/EU)

Firms looking to export products and services which do not benefit from passporting rights under EU Single Market directives are required to obtain specific authorizations in each individual EEA member state.

When the UK exits the EEA, FIs established in the UK would lose their passporting rights unless an alternative trade arrangement for access is negotiated. UK-based FIs would, in this case, be treated in the same way as firms based in a non-EEA state wishing to operate in the EU market, such as the US or Switzerland.

¹ The European Economic Area (EEA) extends EU provisions on its internal market to countries in the European Free Trade Area (EFTA). Along with EU nations, the EEA includes a further three EFTA states (Iceland, Liechtenstein and Norway), which unites them into a Single Market governed by the same basic rules.

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Crucially, the UK Government has indicated that it is prepared to leave the Single Market without a new trade agreement in place. Individual UK based FIs would have to apply directly to the financial regulators in each territory for permission to conduct business there (and may be required to establish branches in each country), or establish an authorized presence in an EEA member state from which they can then apply for passporting.

Retail banks and investment banks

- ▶ Passporting largely covered by CRD and MiFID
- ▶ Credit institutions that have passport rights under the CRD do not have passport rights under MiFID (although credit institutions can passport investment services under the CRD)
- ▶ Eligible deposits of an EEA branch will be covered by the home rather than host country deposit guarantee scheme. However, eligible deposits placed in UK branches from outside the EEA are covered by the host deposit guarantee scheme

Asset management

- ▶ Passporting largely covered by MiFID, UCITS, AIFM, and the Insurance Mediation Directive (for advice on insurance-based products)
- ▶ The AIFMD requires hedge funds to locate significant management functions in the EU

Insurance

- ▶ Passporting largely covered by Solvency II and the Insurance Mediation Directive
- ▶ Firms passporting under the Solvency II Directive are automatically able to passport mediation business and therefore do not require a separate passport under the Insurance Mediation Directive

EU Equivalence

By recognizing a non-EU Financial regulatory and supervisory regime, EU regulators can rely on supervised entities' compliance with the "equivalent" foreign framework. This assessment is based on detailed criteria and looks to confirm that it achieves the same objectives as the EU legislation.

Switzerland's provision of financial services in the EU is an interesting illustration due to its geographical proximity to the EU and the importance of its FS sector. Around 20 equivalence agreements have been struck between the EU and Switzerland due to the specificities of each financial services sub-sector covered. In order to reach these agreements, Switzerland has had to largely adopt EU frameworks in its national regulation, and must adapt them in line with changing EU regulations so as to maintain their validity.

In the absence of an equivalence agreement, UK based FIs would need to either:

- ▶ be established as an authorized entity in individual member states in relation to the relevant directives(s),
- or
- ▶ establish an authorized subsidiary in a member state and rely on passporting rights across the EU.

Harmonized regime under MiFID II

MiFID II creates a harmonized regime for access to the EU Single Market for non-EEA investment firms. An equivalence agreement is required for the regime to apply. Qualifying non-EEA firms would then be able to service eligible counterparties including professional clients (but not retail clients) without having to establish a branch in each EEA member state. There are concerns that in practice it will require non-EEA firms to establish subsidiaries in the EEA to benefit from passporting, implying capital requirements, host state supervision as distinct from home state oversight and home state deposit insurance guarantees.

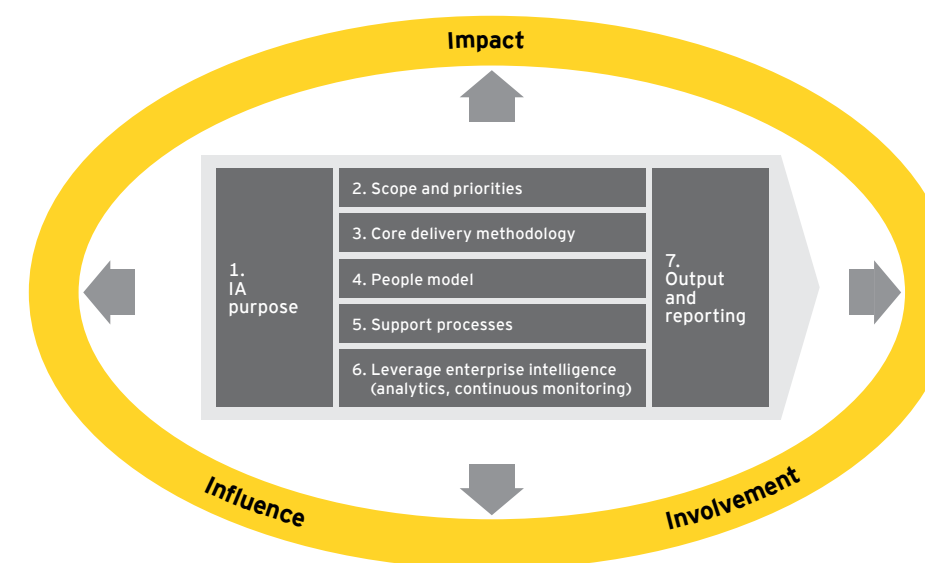
Access to talent

The Prime Minister stated that the UK Government will remain open to international talent. However, the UK will control its own borders. The Government stated that they are looking to guarantee reciprocal rights to EU citizens living in UK and vice versa early in the negotiations. However, it is not clear what the exact arrangement and / or criteria for obtaining working rights for international talent will be.

FS organizations need to consider how their people strategy may change to reflect the change in immigration rules.

What Brexit means for Internal Audit

IA functions should consider carefully the immediate impact the vote to leave will have on their operating model. Two areas it will impact within the IA operating model are IA's scope and priorities and IA's people model.



Scope and priorities:

Brexit will have a number of direct and indirect impacts on IA's scope and priorities. For instance, the CIIA code² requires IA functions to include within its scope key corporate and strategic events, such "as a significant business process change." It is safe to conclude that Brexit is a key corporate and strategic event for most financial institutions.

As a result, IA should evaluate whether the associated key risks with this change/program of activity are being adequately addressed and reported. IA should also assess the effectiveness of key Brexit governance committees and related change programs and whether the information being used in such key decision making is "fair, balanced and reasonable."

Taking a broader view, the CIIA code states "the primary role of Internal Audit should be to help the Board and Executive Management protect the assets, reputation and sustainability of the organization". It discharges this role and mandate by focusing on the biggest risks to the organization. With a strategic event of this magnitude, this will trigger a number of changes in the external environment. These will inevitably change the risk profile of the organization and see the emergence of new risks. As the UK prepares to leave the Single Market, IA must ensure their risk assessment and audit planning process are dynamic and suitably agile to react. Key questions for IA management to consider are:

- ▶ Given the economic uncertainty and changing external environment, is the audit plan still relevant?
- ▶ Is the planning process flexible and agile enough to accommodate new and emerging risks? Is a 3 + 9 audit planning model more suitable to deal with the uncertainty that lies ahead?
- ▶ Does the audit universe encompass all the key risks?
- ▶ Does the audit universe accurately capture the risk profile of the organization, including the changes in the external environment and in the business, post the vote to leave?
- ▶ Is the audit universe able to reflect the impact of leaving the Single Market?
- ▶ Is the audit plan refresh assessed against the changing risk profile of the organization?

² The Code for Effective Internal Audit in the Financial Services Sector, Recommendations from the Committee on Internal Audit Guidance for Financial Services. Issued in July 2013 by the Chartered Institute of Internal Auditors.

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People model:

The largest challenge that IA will face in the future is its ability to deploy audit staff of the right calibre³. We believe that during the next two to three years the depth and breadth of IA’s skillset will be tested. IA will have to develop a people strategy which accounts for both the footprint of the organization, as well as stricter UK border controls. IA functions and management should critically assess:

- ▶ Does IA have the right skills to provide sufficient coverage of Brexit related risks e.g., loss of passporting, change, tax, human capital, credit etc.?
- ▶ Does IA have the right skills to assess and challenge the financial Institution’s Brexit plan?
- ▶ Do IA professionals have the sufficient skills and experience to apply more judgement on outcomes?
- ▶ Do IA professionals have the standing and capability to constructively challenge the business through the Brexit process?
- ▶ Is there agility within the IA people model to divert resources where required (both in terms of skills and logistics of overseas coverage)?
- ▶ Does IA have a plan for changes in employment status and its impact on their staff?
- ▶ What are the location, employment and/or visa requirements, of significant roles across your EU operations?

What’s next?

Given the uncertainty that lies ahead, the easiest option in many cases would be to do nothing until there is certainty around the exact exit negotiations. Until the exact terms of the UK’s exit from the EU are determined, the external economic and political environment will change and subsequently, so will the risk profile of businesses. As a minimum, we would encourage IA functions to continually consider the impact this will have on their scope and priorities and people model.

How can we help?

EY is the leading provider of IA services both globally and within the UK, with a market share approaching 50% of the Business Global Week 1000. In the last 12 months, we have provided support to almost 3,000 clients globally. We have the largest FS Risk and IA practice in the UK and across EMEA of any of the other professional services firms, with over 1,800 dedicated FS Risk professionals, drawn from an overall FS business of 10,000 professionals.

This market leading position, as well as our experience in the delivery of a number of IA improvement programs means we are well placed to help your function to:

- ▶ Identify how Brexit may impact your current operating model
- ▶ Develop pragmatic recommendations to address the challenges
- ▶ Design, embed and measure Brexit-related changes

³ Are we nearly there yet? New challenges ahead for internal audit in financial services.
[http://www.ey.com/Publication/vwLUAssets/ey-RG2020-future-of-internal-audit/\\$FILE/ey-RG2020-future-of-internal-audit.pdf](http://www.ey.com/Publication/vwLUAssets/ey-RG2020-future-of-internal-audit/$FILE/ey-RG2020-future-of-internal-audit.pdf)

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EYG no. 00034-174GBL
ED None

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