Internal audit priorities in the financial sector

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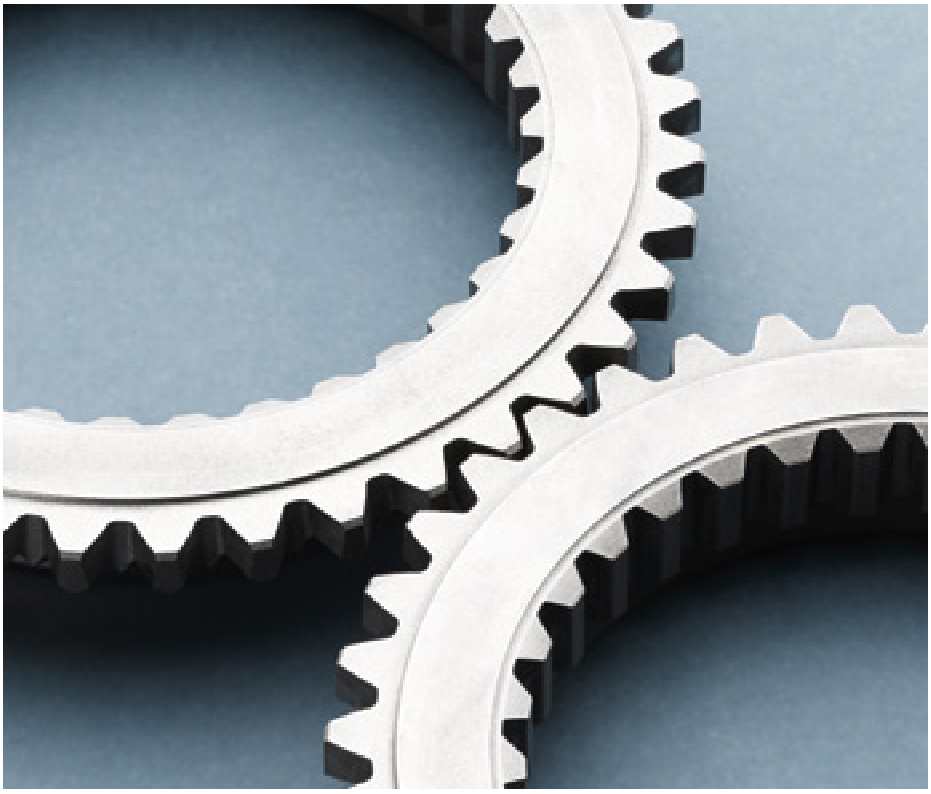
In an era of continued challenges around conduct and behavior for firms, regulators and boards are more aware of the issues and prepared to act. Customers and clients continue to expect more from the industry with work well-progressed on topics such as the Senior Managers Regime and Conflicts of Interest.

This leaves a critical question for internal audit functions to address—how does their work provide confidence in the conduct and behavior of firms, and ultimately help build trust with customers and clients? Are they focused on the priorities that matter? In addition, we should expect market disruption, innovation, and changing business models to put pressure on internal audit functions. The expectations on internal audit to cover the basics while adding more insight and value—being a genuine partner and critical friend—continue to grow. Many organizations are seeking to enhance growth and returns to build market share or access new technologies through acquisition, development into new markets or products, or partnerships to access talent. This adds pressure on internal audit to have a credible opinion on topics which in some cases didn't exist a year ago. Making an impact is becoming more challenging.



Economic Outlook

Growth in the United Kingdom for 2016 has been better than many economists had expected. Output in the first half of the year surpassed forecasts and, going in to June's EU referendum, markets were buoyed.

The outlook for the UK economy now and in 2017 will be shaped, in many ways, by how the economy responds to the UK's surprise vote to leave the EU. Following Brexit, economists have cut their average forecasts for growth in 2017 from 2.1 percent to 0.4 percent.

For the UK to experience a full-blown recession, consumers, who account for two-thirds of GDP, would need to stop consuming as they did in 2009-10. Forecasts suggest inflation will rise to 2.4 percent in 2017 on the back of a weaker pound and higher import prices, hitting consumers' take-home pay. Economists surveyed by Bloomberg in July give a 40 percent probability of the UK sliding into its first recession since 2009, up from 18 percent in June.

As things stand at this publication's date, the scale of the predicted downturn is not comparable to that which followed the collapse of Lehman Brothers in 2008. In this respect, the impact of fiscal, monetary, and regulatory policies will be crucial.

In response to weaker growth expectations, policy has become more accommodative. Chancellor Philip Hammond has abandoned the previous chancellors' target of reaching a surplus by 2020, and has stated a willingness to loosen fiscal policy to boost growth. The Bank of England cut interest rates further, to a new record low of 0.25 percent, and engaged in further monetary stimuli.

Thus it seems that the UK economy faces slower growth in 2017, albeit a milder slowdown than in the last recession, and with the opportunity for policy-induced stabilization.

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Regulatory Outlook

Regulatory expectations continue to evolve and expand. Regulatory attention has, in most instances, moved beyond the planning phase and is now focused on implementation. Strong ethics, culture, and accountability at every level of the organization are now as important as financial resilience.

New regulatory requirements and expectations across a range of conduct and prudential topics that have recently come into effect include the Senior Managers Regime, MiFID II/Markets in Financial Instruments (MiFIR), and Basel Committee on Banking Supervision (BCBS) 239, as well as requirements tackling financial crime, consumer credit, and conflicts of interest, among others.

Furthermore, the Bank of England is expected to continue carrying out stress-testing exercises throughout the coming year. The European Commission's report on how market liquidity can be improved, and the potential impact of reforms and market developments, is also to be published. The report and policy proposals are expected to be published by The Financial Stability Board (FSB) on the need for additional prefunded financial resources and liquidity arrangements for Central Counterparties (CCPs). This is expected to be accompanied by standards and guidance on CCP resolution planning, tools, and the cross-border coordination and recognition of resolution decisions.

Additionally, a particular area of current supervisory emphasis is each institution's ability to respond to shocks or crises. The current list of possible risks is long, with consequences for macro¬economic and financial market instability and dislocations. These put the spotlight on IT infrastructure, contingency planning, and stress testing, among others.

Some banks have exited markets and changed how they participate in other markets, often leading to an influx of non-bank financial companies. This shift is prompting regulators to examine how regulatory requirements need to adapt to accommodate and respond to new entrants, and the new risks to the overall stability of the financial system they bring.

Additionally, these changes introduce new risks and challenges for banks themselves, since exiting an existing market or entering a new one is rarely straightforward.

When tackling regulatory change, many organizations have traditionally operated reactively, only making changes in response to a particular regulatory deadline, supervisory direction, or other type of regulatory pressure. However, organizations have increasingly started to shift toward a more proactive stance, with a more strategic approach to managing regulatory change and by establishing stronger links to business strategy and engagement with the regulators.

A forward-looking regulatory strategy creates opportunities to better align regulatory responses with business objectives. It can also improve the efficiency of implementation. By identifying connection points between regulatory and business strategies—instead of managing regulatory strategy as a side activity—banks can discover ways to achieve common objectives more efficiently and align compliance activities with their broader organizational goals.

Retail Banking outlook

Cost savings

Banks' core competitive advantages are being eroded by technology. Specifically, technology-enabled innovation, which leads to the rise of non-bank competition (e.g., Fintechs—although this also affects the insurance and investment management sectors) in areas such as payments. Additionally, the proliferation of non-bank Fintech organizations is disintermediating the traditional banking value-chain, which has historically been organizations largely owned or controlled by incumbent banks. This will make the fight to generate returns above the cost of capital particularly challenging.

Channels are key, particularly in terms of whether digital and non-proprietary distribution can reduce variable front-line costs, and whether increased straight-through processing (STP) can help rationalize the middle and back office. New analytical capabilities may enable banks to optimize their client relationships through their branch networks, and enable them to exploit their unrivalled treasure-trove of data.

Managing Innovation

Emerging business models are using new technology to re-invent key elements of FS, e.g., payment specialists and marketplace lenders. The danger is not that non-banks replicate the universal banking model, but rather that by innovating around it in support of their own core business, they fundamentally undermine the traditional integrated bank business model.

Banks' growth models and strategies should closely link to the digital customer and tech-enabled disruption. The question here is how banks can best "future proof" themselves at a time of considerable uncertainty and when shareholders are demanding a focus on cost efficiency. This is tied to how banks collaborate with Fintechs, including through investments and acquisitions of Fintechs, as well as cultural points around employee incentives and capabilities. It also requires a framework to understand which areas are priorities for investment.

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Capital Markets outlook

Operational and conduct risks

The use of high frequency, electronic, and algorithmic trading practices within wholesale markets increases the susceptibility to operational risk events and poor conduct outcomes for clients. Often this is a result of historical programming development, IT issues, and a weaknesses in governance. While the global regulatory landscape is both comprehensive and complex, there is a growing regulatory expectation that firms demonstrate better compliance of electronic trading regulatory requirements. This has led to a greater focus within firms to have a common, homogenous approach that is applied in electronic algorithmic trading governance. This ensures best execution and compliance with MiFIR/MiFID II.

Bank of England's Fair and Effective Markets Review

The Bank of England's FEMR, issued in June 2015, concluded that Fixed Income, Currency, and Commodities (FICC) markets require stronger collective processes for identifying and agreeing on standards of good market practice, consistent with regulatory requirements, which respond more rapidly to new market structures and trading patterns. As a consequence, the FICC Markets Standards Board (FMSB) was established. This body is now defining and sustaining good practice standards for FICC markets to raise standards of behavior, competence, and awareness across those markets. The work of the FMSB is a timely reminder for firms to reconsider the application of established practices in wholesale markets.

Innovative technologies

Many capital market institutions are currently piloting and adopting innovative technologies, some of which are likely to have far-reaching consequences for their value chains, processing capabilities, and control frameworks. While many Fintech, and especially blockchain, initiatives are in the early stages, the implications for internal audit functions are significant and will require close interaction to maintain strong business and technology controls.

Insurance outlook

Conduct

In their 2016/2017 business plan, the Financial Conduct Authority (FCA) has emphasized that insurers need to check that they take steps to positively address the known behaviors and traits that consumers may exhibit, rather than seeking to capitalize on them. The FCA also outlined that unfair contract terms will come into sharper focus as the Consumer Rights Act is due to come into force. Part 2 of the Act deals with unfair contract terms in a wide-range of sectors, including insurance, and the FCA will widen the scope for the assessment of fairness.

Digital innovation

Many parts of the insurance industry now are either technology-related or have technology as a key driver. Trends such as growth of peer-to-peer insurance, cyber insurance, gamification, aerial and digital imagery, and customer adherence apps will have a larger role to play in future. Startups are emerging in the insurance sector with fresh, innovative, and potentially popular business models. New peer-to-peer startups claim to be 80 percent cheaper than traditional policies, for instance.

Internet of Things and Big Data

The growth of internet connected devices and sensors, which are projected to number 50 billion by 2020, is changing the insurance market. Through the use of low cost of sensors, improved communication, and increased data processing power, the Internet of Things is fueling the rapid growth in the availability of real-time or near-real-time information—a trend often referred to as Big Data. Insurers who can exploit this information to identify customers' needs and risks and to support better pricing, underwriting, and loss control will have a distinct competitive advantage over their peers.

Change in business models

Over the last five years, insurance business models have evolved significantly to embrace the digital age, often through an increased use of outsourcing and specialists. As such, insurance business models are exploiting growth opportunities to meet ever-changing consumer needs. Similarly, delegated underwriting and claims handling firms are increasingly engaged, either to bring in specialist skills or access new markets globally.

Investment Management outlook

Industry and Technology

Scale and process advantages of established investment management players are diminishing over time. The playing field will level as firms of all sizes take advantage of emerging networks and platform-based services to lower cost, improve compliance, and focus on markets with true competitive advantage.

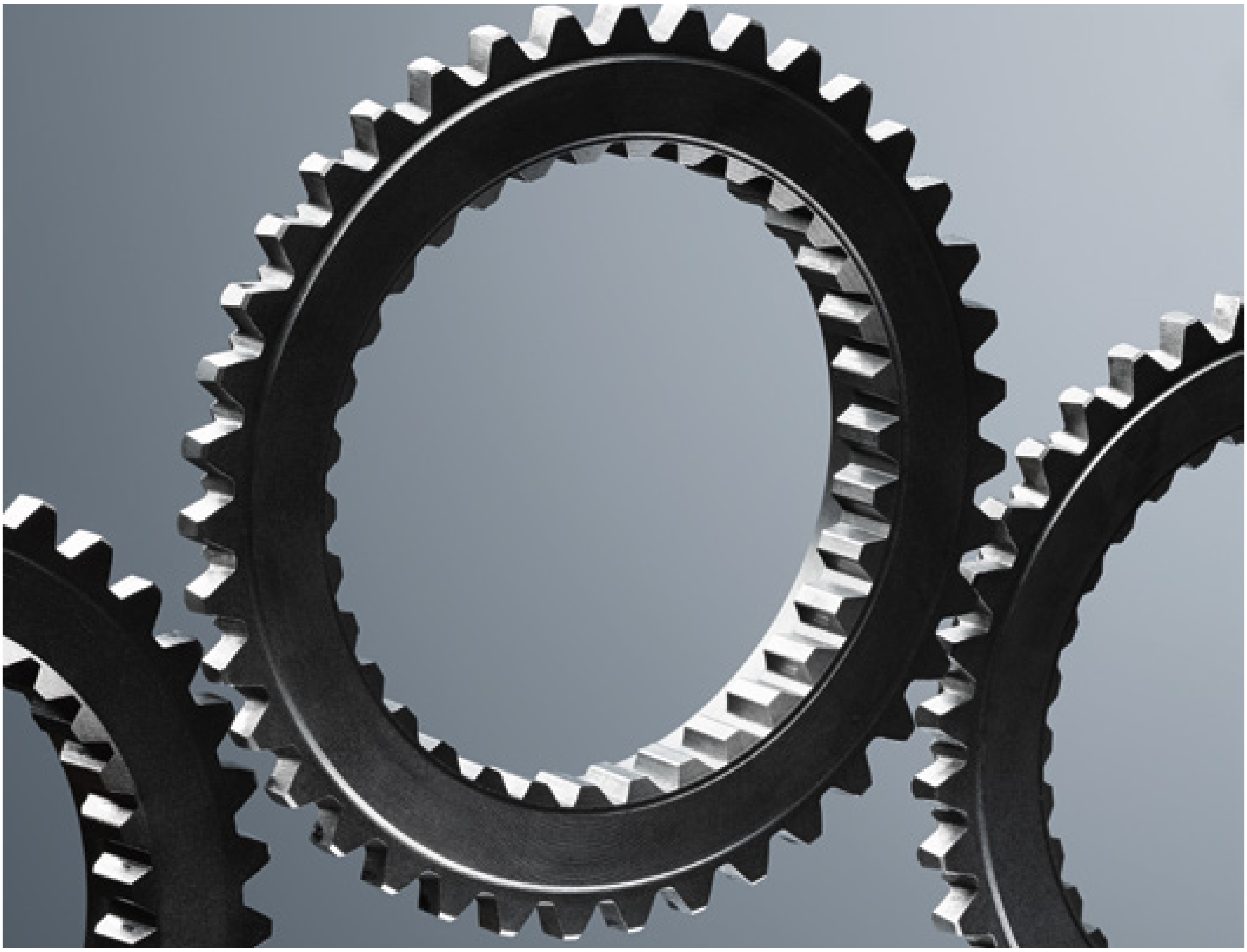
Product and Customer

Cognitive technologies and automation will enable the targeting of new investor segments through lower costs and increased customization. Increased sophistication of robo-advice will alter distribution models, forcing fewer traditional advisers to move upmarket.

Business and operations

Strong above-market performance history has helped traditional investment managers navigate headwinds ranging from slowing fund inflows to share gains by absolute return and passive strategies. Rising transparency, and consequent fee and margin pressure, remain.

Interest in managed service solutions to drive front and back office cost savings will accelerate, both in core trading and customer records management. Several UK big fund houses have joined forces in testing blockchain technology by cutting out intermediaries and reducing staff. It is also viewed that blockchain will likely be gradually adopted for reconciliation, clearing, and settlement, which would increase accuracy and speed while decreasing costs.



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