New approaches
2018 Planning Priorities for Internal Audit in Financial Services
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Focus on your Conduct and Culture Programme

Culture and Corporate Governance
Culture in financial services firms remains a priority for the FCA and PRA. Culture drives individual behaviours which in turn affect day-to-day practices in firms and their interaction with customers and other market participants. Culture is therefore both a key driver, and potential mitigant, of conduct risk.

Senior Managers Regimes
Internal Audit functions are likely to conduct audits with an emphasis on clarity of individual accountabilities, delegated authorities and legal entity-specific governance arrangements.

Competition, Innovation and Strategy
The FCA has expressed concerns that there is a lack of competition and innovation within retail banking, which could be having a detrimental affect on consumers through either product value for money or access to financial services.

Customer vulnerability
The FCA continues its focus customer vulnerability noting that vulnerable customers are more susceptible to harm and generally less able to advance their own interests.

Increase Focus on Technology and Disruption

Data Analytics
Analytics can create efficiencies in the audit function through automation or drive insights to provide clear and actionable outcomes for the business.

Cyber Risk
Cyber risk has been highlighted as a focus area by a number of regulators in recent years and we expect greater supervisory scrutiny from the FCA in 2018, as the FCA is increasing its specialist knowledge in this area and there has been supervisory activity at individual firms.

Robotics and automation
A recent Deloitte survey on Robotic Process Automation (RPA) noted a sharp increase last year in the number of organisations that have investigated RPA, and a significant number that have already implemented or piloted RPA.

Blockchain and financial infrastructure
Several FS players are examining how Blockchain technology can be used to make the settlement process more efficient and cost effective, with a view to system launches as early as 2018.

Fin Tech and Disruptive Technologies
Disruptive technologies and its practical business application are at the forefront of digitalisation and innovation initiatives and are expected to revolutionise the way the financial services sector operate, trades, or service customers.

GDPRs
Connected to the challenge of winning customers’ trust is the issue of how to collect, store, manage and use customer data securely, and firms need to ensure that they fully take into account current and future data protection regulations as they design their solutions.
Strategically manage Prudential and Regulatory Requirements

Financial Reporting
IFRS 9 will impact your organisations credit landscape and introduce a number of strategic and business challenges.

Prudential Regulations and Regulatory Compliance
Your organisation could use data that exists within Solvency II and that for other firms which is publically available, to identify unusual trends to focus independent challenge.

Structural Reform/Banking Reform
2018 will be a significant year for banks currently working to implement the various structural reform requirements that come into force on 1 January 2019.

HMRC Common Reporting Standard
Financial Institutions are now expected to have completed all their remediation work by the end of 2017 and to report as appropriate in 2018.

Market Risk

Model Risk Management (MRM)
An effective MRM Framework enables active management of model risk across diverse model classes within a defined model risk appetite as set by the board.

Credit Risk
Intensified regulatory requirements, increasing uncertainty of the economic environment and the continuous pursuit of competitive advantage have kept credit risk management at the top of the financial services agenda.

Corporate Criminal Offence
New legislation comes into force on 30 September 2017 and HMRC expects businesses to have taken the initial steps to comply by this date.

Brexit Effect on 3 Lines of Defence
The terms of access which the UK negotiates to the Single Market will be fundamental to future strategy and business models.

Enhance the Structure and Capabilities of Risk Management

Risk Management Framework
The drivers for embedding risk management frameworks are increasing regulatory pressures, reduced operational loss exposures and increasing competitive advantages deriving from informed management decisions.

Risk Appetite Frameworks (RAF)
An effective RAF enables pro-active management of the risk profile within the defined risk appetite as set by the board.

Financial Crime and AML
From a UK regulatory perspective, the FCA’s unrelenting focus on financial crime continues, particularly in relation to AML.

Risk Adjusted pricing and performance management
Review the firm’s ECAP/Pillar 2 capital frameworks, models, and parameterisations and ensure they are aligned with the up to date regulatory guidance. Review the firm’s Risk-adjusted return on capital pricing model and assess its consistency with the upstream model inputs, in particular IFRS 9 impairment.

Operational resilience
Organisations are facing increasing amounts of uncertainty and disruption, bringing both risks and opportunities, which more resilient organisations are better prepared to overcome and gain from.

Agile Internal Audit
An Agile Internal Audit approach provides methods that work to change both the mindset of Internal Auditors and their work processes.
Introduction

Internal Audit is not an isolated or standalone activity as it needs to be responsive to business issues and change, and provide confidence in the outcomes firms generate. Now is the time to be focused on new approaches to the core purpose of providing assurance.

In this 2018 edition we continue a focus on market disruption, innovation and changing business models. When aggregated with external factors such as assessing the impacts of Brexit or revised regulatory demands there is a natural consequence for Internal Audit functions to focus on their own functional transformation to deliver heightened impact and influence to their firms.

Many firms – large and small – are now focused on new approaches to delivering against their mandates. Enhancing the efficiency and effectiveness of a function is key to increasing Internal Audit’s contribution to organisational success.

Some interesting topics featuring in Internal Audit transformation that are worthy of consideration are:

**Agile.** Building momentum is the adoption of agile disciplines and concepts in the delivery of Internal Audit engagements. While the phrases and descriptions use a new language for many, the fundamentals provide an opportunity for functions to focus on the fundamentals – being disciplined about the intended outcome of our work, engaging well with our teams and stakeholders, and raising the project management disciplines we often audit to our own work.

**Artificial intelligence and robotic process automation.** A key development for many firms that impacts Internal Audit in both their ability to effectively audit these tools, as well as assessing how these technologies can be applied to the business of Internal Audit. As either an enhancement of data analytics capability or in automating MI and reporting or the execution of routine testing, this is a topic we expect to gain prominence in leading functions.

**Guest auditors.** An option being considered in many functions is using skilled colleagues from the organisation to supplement Internal Auditors. Whilst there is a potential conflict risk that needs to be recognised this is a way of adding subject-matter expertise as well as building engagement with business stakeholders.

We hope this edition contributes to your 2018 planning process.
Section one – Outlooks
Economic outlook

Following a resilient 2016, economic activity in the United Kingdom has softened in the first half of 2017. Markets remain buoyed by easy monetary policy and a strengthening global recovery, but higher inflation – on the back of a weaker pound – has eroded households’ real incomes growth and began to weigh on consumption.

Following last summer’s Brexit vote, the UK economy surprised many economists with its initial resilience to the shock. Consumer spending and corporate optimism soon recovered their post-referendum losses and the economy grew at a relatively healthy 1.8%.

However, the vote left a more lasting mark on the value of the pound, with sterling falling around 13% on a trade-weighted basis in the year following the vote. This devaluation has now fed through to higher import prices and markedly higher inflation. Consumer prices are forecasts to rise 2.7% in 2017, up from just 0.7% in 2016 and 0.0% in 2015.

The rise in inflation is forecast to wipe out any rise in average incomes for UK consumers, who contribute to around two-thirds of economic activity. As such, forecasts suggest growth is likely to remain sluggish in the near-term as the squeeze on households’ real incomes continues to weigh on consumption.

Growth in the UK is forecast to soften to 1.6% in 2017 and then 1.4% the following year.

In the current environment, monetary policy is likely to remain accommodating for a while longer. Markets have pushed back expectations of a rate rise to later in the year and rates are only forecast to nudge up gradually thereafter, despite elevated inflation.

On the upside, prospects for growth globally have continued to improve. The International Monetary Fund raised its forecasts for the growth of the world economy to 3.5% this year and 3.6% in 2018. The improved global outlook has been driven by better prospects in the US, a number of emerging market economies and, in particular, the euro area.

On the back of strengthening global growth and the weaker pound, British firms have seen a sharp increase in demand for their exports.

After contracting through much of 2016 UK goods exports are growing at an annual rate of over 6%.

Confidence in UK manufacturing, a sector which exports roughly half of what it produces, is running at the highest level in 30 years. Exports account for around 30% of UK GDP and the hope is stronger exports will help partially offset the effects of the consumer slowdown.
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Regulatory outlook

2018 will bring significant challenges to financial services firms across EMEA in the form of continuing macro-policy uncertainty, the implementation of a demanding and still evolving regulatory agenda and other market developments putting pressure on the industry.

Key considerations for Banking

Prudential rules | The use of (internal) risk models
Regulatory attitudes towards the use of internal models for regulatory capital calculations continue to harden, with greater focus on oversight and management of models and model risk, as well as senior management/Board understanding.

Regulatory divergence | Knock-on effects on client projects
Timelines are not aligned for some major reform areas, causing practical challenges across borders, most notably for FRTB, on which some clients are looking to comply with the 2019 internationally set deadline.

Key considerations for Investment Management

Reporting, disclosure and best execution | Streamlining systems and controls
Conduct risk controls remain among the top regulatory priorities. The UK Senior Manager and Conduct Regime will be extended to all regulated financial firms by 2018. MiFID II imposes requirements on board composition and diversity, with stricter rules for “significant” firms, as well as rules around incentives and conflicts of interest for sales staff. Firms should link their conduct risk MI to their strategy, target culture and risk management framework. The Board should regularly discuss the firm’s MI on conduct and culture.

Key considerations for Insurance

Data privacy | GDPR compliance and scrutiny of big data
EU General Data Protection Regulation (GDPR) will apply from May 2018, expanding the definition of personal data, and introducing new requirements around data transfers, permissions, notification requirements, and more. Governance structures will be important, including appointment of a data protection officer.

IFRS 17 | Implementing new accounting standard
IFRS 17 (released in H1 2017) will be complex, introducing fundamental differences in liability measurement and profit recognition, and affecting remuneration policies. Whilst the standard does not come into effect until 1 January 2021, it is already on insurers’ work plans. Over the next two years firms should start considering length of implementation projects, year-end reporting timetables, data collection and storage issues.

Key considerations for Capital Markets

Brexit | From contingency planning to execution
Potential loss of passporting and access rights under EU legislation, such as MiFID II and EMIR, will have implications for how UK firms provide investment services to EU clients and how EU clients access UK market infrastructure (e.g. trading venues and CCPs) and vice versa. EU Commission proposals on EUR clearing arrangements will cause firms to consider business model and location arrangements.
Disruption outlook

There are new forces acting on the industry that have the potential to shift the competitive landscape, creating new risks and opportunities. FinTechs have materially changed the basis of competition in financial services, and have laid the foundation for future disruption. There is a need for understanding transformative potential of new entrants and innovations on business models in financial services.

Until recently, data visualisation tools required a programmer’s knowledge to configure and use. No longer. Today, user interfaces have been refined and simplified, putting power of advanced visualisation technology into the hands of typical users. Internal Audit can leverage these tools to make data speak and tell its secrets, helping to intercept issues before they become problems and yield insights that become opportunities. And in doing so addressing the challenges of “making an impact” we raised last year.

Ask a human to perform a mindless and repetitive task, and you’ll get a predictable outcome: falling accuracy and rising inefficiency over time. Instruct a software robot – “bot” – to perform the same task, and quality and productivity remain consistently high.

Robotic Process Automation (RPA), deployed for processes that are clearly defined, repeatable, and rules-based, can result in significant time savings; tasks that take a person hours can be completed by bots in a matter of minutes. The implications of RPA for Internal Audit apply both to the function – automating selected audit procedures, thereby freeing up IA staff for higher-value activities – and to the larger organisation – auditing RPA usage within the business. An emerging challenge for IA functions is whether they have sufficient skills to audit tasks being undertaken by a bot, with read-across to reviewing complex models in recent years.

The underlying technology may be esoteric, but the benefits are readily apparent: Blockchain holds the promise of making information more secure and transactions less costly. A decentralised, widely distributed, encrypted network of ledgers or databases, Blockchain can cut out intermediaries (such as banks, businesses and governments) while enabling financial transactions, supply chain auditing, intellectual property protection, smart contracts, identity management, stock trading and more. The Economist and Harvard Business Review predict that Blockchain will profoundly impact how business is conducted. Internal Audit must be ready to assess. There is also a need to understand the transformative power of Blockchain on shaping the future capabilities and characteristics of financial infrastructure.
Section two – Sectors
Retail Banking Sector

The Open Banking Standard, along with the EU’s revised Payment Services Directive (PSD2), has the potential to transform the traditional retail banking business model.

From 13 January 2018, nine of the UK’s largest retail banks will be required to grant third parties access to consumer and SME current account transaction data. The Competition and Markets Authority has mandated that these banks form an Open Banking Implementation Entity, together with representatives of third parties and consumers, to develop a common standard via which this access is granted. This is known as the Open Banking Standard, and will take the form of an application programming interface (API).

Third parties could create account aggregator tools, via which consumers can view and manage their accounts from different providers via one interface. Price comparison websites could use customer transaction data to offer personalised comparisons of different banking products. 2018, therefore, could see incumbent banks lose the primary customer relationship and become increasingly commoditised.

Banks will have key strategic choices to make as open banking comes into force. Will they choose to simply comply, in the belief that customers will not trust banking services from non-traditional players? Will they choose to take a cautious approach to innovation, incrementally adding new services to their existing digital offerings? Or will they choose to fully embrace the opportunities stemming from open banking to transform their digital offerings, and, potentially, even their business models? Incumbents could use the opening up of data to provide account aggregator services via their existing banking apps. They could even allow customers to initiate payments from accounts held with other providers. Moreover, incumbents can use the new data available to create new, data-rich value-added services.
Data
Those banks that are most adept at acquiring and harnessing data to both drive business insights and add value to customers will be best placed to take advantage of the opportunities open banking offers. Incumbent banks already have access to vast amounts of customer data. Some, however, have difficulties in making optimal use of this data as it is often stored in product ‘silos’, using legacy IT applications which often do not communicate with each other well. A key priority for incumbent retail banks in 2018 will be to optimise their data storage to enable a holistic view of the customer. Banks should then use cognitive analytics to better understand how their individual customers make decisions. They can then use this information to engage individual customers with personalised services.

A shift to a more agile, ‘fail fast and learn quickly’ culture will be a key priority for banks looking to embrace open banking and compete with new, technology-enabled entrants. Incumbents will be looking to erode departmental and product ‘silos’ to foster internal collaboration, and move to a less hierarchical structure where responsibility is more widely distributed.

Working within an ecosystem
Banks will look at ways to continue collaborating with innovative FinTech firms, either to drive internal efficiencies or deliver new or improved customer propositions. UK retail banks are in a unique position to do this owing to the strength of London’s booming FinTech industry. However, incumbent banks can also look further afield to take advantage of the distinct strengths of other FinTech hubs to earn competitive advantage.

Leadership and culture
Banks will need to place innovation at the heart of their business to fully exploit the opportunities introduced by open banking. This begins with the leadership, who play a vital role in ensuring innovation is prioritised throughout the business, encouraging employees to be innovative or even disruptive.

IA Challenge
- Analyse the risks open banking could pose to your organisation’s current business model.
- Develop a strategy to audit API.
- In which products and in which segments of the value chain should you be focusing your “Open Banking” investment?
- Understand additional cyber and fraud risk associated with opening up of customer data.
- Understand the conduct risk associated with potential propositions.
Capital Markets Sector

Over the next 18 months, more firms will come within scope of EMIR margining requirements for non-cleared derivatives, and clearing obligations will kick in for additional types of derivatives.

**Strategic and operational challenges of new venues and infrastructure**

In 2018 and beyond, with the application of the trading obligation for derivatives and equities, transparency rules, and new rules for trading venues and Systematic Internalisers (SIs), we will see an increase in trading on platforms and establishment of new trading venues and SIs.

Firms will need to consider strategic and cost implications of new venues, gain authorisation and registration, and meet strengthened controls and transparency requirements. They will need to connect to these new platforms and venues, which will require further investment.

**Data and reporting**

MiFID II, EMIR, CSDR and SFTR introduce increased transaction reporting requirements and will require firms to ensure that they have the right infrastructure in place. Firms can also make use of new data sources available to them for their own internal initiatives, such as best execution and market abuse monitoring.

Firms will also continue to address system constraints related to implementation of the new market abuse controls and improving trade surveillance. Firms will be looking into RegTech solutions for transaction reporting requirements, client disclosure and investor protection rules under MiFID II, Packaged Retail and Insurance-based Investment Products (PRIIPs), and market surveillance.

**Disrupting investment research market in the EU**

From 2018, MiFID II will require research to be paid for either through a research payment account (RPA) funded from an explicit charge to investors, or out of the investment manager’s own P&L. Investment managers are expected to reduce their purchase of sell-side research and increase their use of in-house analysts. Sell-side research providers will need to respond to reduced revenues and increased competition. There will also be governance and operational challenges around finalising pricing models and building systems to accommodate new payment and distribution structures, particularly for fixed income research.

**Strategies on clearing, collateral management and settlement**

Firms will be looking to restructure their product offering to gradually withdraw from non-standardised derivatives offerings. Smaller firms will still need help with developing initial margin models and addressing operational issues, i.e. re-papering, updating policies and IT infrastructure.

Regulation, including margin requirements, is increasing demand for collateral, placing pressure on firms’ operational capabilities in respect of collateral management. Firms will be increasingly looking into outsourcing their collateral management functions and will need help developing their target operating models. New reporting and stricter settlement discipline that will be introduced under the CSDR, including management buy-ins and penalties, will require revisiting settlement strategies and changes to client documentation and contracts.
Insurance Sector

‘Model risk and model drift’ has been introduced as a new theme, reflecting the current focus of regulators on this topic. Ageing population has been added as an aspect of the perspective on the treatment of customers.

Hunt for profitability
Life insurers are being forced to change long-established practices and business models. A key driver for product innovation and digitalised services is the FCA focus on vulnerable customers.

Accelerating ‘InsurTech’ developments and digital transformation is critical in a marketplace that is changing more drastically than ever before. However, the ‘soft market’ shows little sign of abating and there is simultaneously an ever-increasing focus on efficiency, underwriting discipline and cutting costs. The search for profitability continues to drive insurers to develop new products, seek alternative distribution channels and markets and find new ways to connect with customers and meet their ever-changing needs.

A key opportunity is developing hybrid products that provide a combination of guaranteed income as well as drawdown flexibility, which may be better suited to some customers’ needs.

Cyber
The insurance sector’s susceptibility to cyber-attacks is growing exponentially as insurance companies migrate towards digital channels and the attractiveness to cyber criminals of the vast swathes of data held by insurers becomes clear. Recent data from the Information Commissioner’s Office highlighted that the number of data breaches reported by insurers doubled in the last year.

As attacks become ever more sophisticated and the regulatory penalties for breaches dramatically increase, insurers need to ensure they are addressing the evolving longer-term threats as well as those currently well known.

Pricing practices and Big Data
Big Data is increasingly being used to support a more accurate and precise estimation of risk and the cost of providing insurance. This has encouraged innovation in the industry and has advantages for customers who can adapt their behaviour to reduce their risk and, therefore, their cost of insurance.

However, attempting to distinguish between ‘acceptable’ and ‘unacceptable’ forms of Big Data is challenging. The extent to which pricing based on behavioural characteristics at the time of purchase and renewal is unacceptable is yet to be clearly determined.

Competition and the treatment of customers
The FCA focus on “vulnerable customers” will lead to greater scrutiny in 2018. Firms’ business models will be affected as they change their practices and reassess how they can ensure profitability under more competitive pressure.

The FCA retirement outcomes review considers additional protections for consumers accessing pension savings. FCA focus on advice provided to consumers, as well as protection for those that do not take advice. Further FCA work in the at-retirement space is expected. Firms will need help in navigating these issues.
There are important changes to competition and FinTech, product governance and distribution.

**Streamlining systems and controls**
MiFID II, PRIIPs and Securities Financing Transaction Regulation (SFTR) bring a range of new disclosure and reporting requirements. Disclosing costs and charges for the first time under MiFID II and PRIIPS will be onerous for firms and from 2019 UCITS funds will also be subject to MiFID II disclosure rules. Regular client-specific post-sale disclosures under MiFID II will also require significant system upgrades for many firms. One of the challenges will be around improving best execution monitoring for non-equities markets.

Upgrading surveillance and controls around market abuse and financial crime will remain onerous. MAR requires firms to monitor and report suspicious unexecuted orders, which currently are not captured by many firms’ systems.

**Competition and FinTech**
The FCA asset management market study proposed remedies to improve the transparency of fund charges and fund performance, reform governance standards, and increase scrutiny of the unregulated investment consultancy market. The measures may accelerate the existing trend towards passive investment strategies. Firms will need help modelling the impact of some measures on their business models.

The recommendations from the Financial Advice Market Review, and regulatory feedback from the FCA Advice Unit, will make it easier for firms offering automated advice to overcome regulatory hurdles. There will be demand for support on compliance with new regulations.

**Product governance and distribution**
New rules on product governance, appropriateness and inducements introduced under MiFID II and new requirements for Key Information Document under PRIIPS will lead firms to review their product range, possibly in favour of more “non-complex” products. Other considerations include increased costs of distribution, which may be mitigated by the use of digital channels.

Remedies proposed under the FCA asset management market study will encourage firms to review the competitiveness of their offerings (particularly around fund management charges) and, as a result, some firms may rationalise their product range. Later this year, the FCA will also release its findings around distribution to retail investors. Firms will need help to review business models to comply with the new regime.

**Disrupting investment research market in the EU**
MiFID II rules require that research must be paid either through a (RPA) or out of the investment manager’s own P&L. Some firms may choose to do more research in-house. Setting up RPAs will have a number of operational implications, including application of VAT and client money rules. Firms will need help in setting up RPAs, including on the operational side, communication to clients, repapering of contracts.
Section three – Planning Priorities for Internal Audit
Focus on your Conduct and Culture Programme

Culture
Culture in financial services firms remains a priority for the FCA and PRA. Culture drives individual behaviours which in turn affect day-to-day practices in firms and their interaction with customers and other market participants. Culture is therefore both a key driver, and potential mitigant, of conduct risk.

Poor culture can lead to poor outcomes for consumers and markets. There is an increasing need for firms to have structures, processes and incentives that support and reinforce the culture they want to promote and prevent poor conduct.

Culture change needs to be driven by the tone from the top but also requires staff to accept and implement the processes in place that drive the culture the firm adopts.

Boards need assurance that a culture of learning from mistakes, rewarding the right behaviour and systems and processes that produce the desired behaviours are being embedded across their organisations. A statement of values is not sufficient on its own; boards need to know that ‘espoused’ values are the same as actual values on the ground. Providing assurance to boards around values on the ground, however, is just part of the picture as culture is not merely the articulation of an organisation’s values.

The FCA will continue to support and drive culture change by:

- Engagement with individual firms through supervision.
- Promoting constructive discussions with various stakeholders including industry and consumer groups.
- Offering support to the increasing number of initiatives outside the FCA on banking culture, such as the work being done by the G30 and by the BSB.
- Demanding high standards of conduct, backed by supervision and enforcement action if necessary, such that an appropriate culture remains a top priority for banks’ management.

IA Challenge
- Are the right management decisions taken at the appropriate level with the right stakeholders?
- Is there sufficient evidence to document rationale and circumstances of key decisions being taken?
- Do Senior Managers delegate their responsibilities in a transparent and effective manner in compliance with their regulatory responsibilities?
- Talent agenda – does your organisation attract the right staff and train and develop staff to address specialist areas?
- Assess if MI culture is objective and contains evidence-based analysis and recommendations.
Corporate Governance
Good governance is critical to delivering a sound and well-run business: and at the centre of good governance is an effective board. The PRA has a major interest in promoting good governance across the financial sector and supporting the work of boards in delivering it.

The Financial Stability Board (FSB) has published a thematic peer review on corporate governance. It takes stock of how FSB member jurisdictions have applied the Principles to publicly listed, regulated financial institutions, identifying effective practices and areas where good progress has been made while noting gaps and areas of possible weakness. The FSB report includes efforts to strengthen governance frameworks to mitigate misconduct risks.

The European Central Bank (ECB) has published its guide to fit and proper assessments. The guide explains how ECB Banking Supervision ensures consistency in the application of the fit and proper assessment criteria.

The Prudential Regulatory Authority (PRA) has also published a consultation paper on substantive changes to recovery planning. The consultation paper includes governance implications such as the expectation for firms to test governance arrangements and whether the firm’s board and senior management can demonstrate how they would execute the recovery plan.
The Business, Energy and Industrial Strategy Committee (BEIS) inquiry report calls for reforms to the UK Corporate Governance Code and greater enforcement. The key recommendations cover:

i. Improved stakeholder engagement by companies (s172, CA2006).
ii. The role and professional development of non-executive directors.
iii. The importance of gender and ethnic diversity to encourage diverse boardroom thinking.
iv. Reform and reporting of executive pay.
v. Board composition and appointment of board members.
vi. Thorough, independent and consistent board evaluation.
vii. A new corporate governance code and enforcement for large private companies.

**IA Challenge**

- Challenge your organisation’s clarity and appropriateness of Terms of Reference, roles and responsibilities, delegated authorities for Board of Directors and relevant committees.
- Review your organisation’s board dynamics and composition – the skills, experience, balance and competence of members.
- Challenge whether MI is linked to the risk appetite of the firm and whether MI is supported by appropriate governance and capabilities, including people, processes and IT systems.
- Align financial rewards with corporate values and provision of fair outcomes.
- Challenge the collective risk management competence of your organisation (knowledge, skills, learning, recruitment, induction and retention).
- Carry out specific culture assessments or consider culture as part of their root cause analysis on all audits.
- Conduct regular assessments of board effectiveness and ensure the board receives adequate training to remain abreast of relevant new laws and regulations.
- Enhance the transparency of the board nominations process, for example, the criteria for nominating individuals to the board, the qualifications of board members and the election process.
- Give shareholders the opportunity to vote on remuneration policies and the total value of compensation arrangements offered to the board and senior management.
Senior Manager Regimes

Internal Audit functions are likely to conduct audits with an emphasis on clarity of individual accountabilities, delegated authorities and legal entity-specific governance arrangements.

The Senior Managers Regime and Certification Regime (SMCR) and Senior Insurance Managers Regime (SIMR) commenced on 7 March 2016. There continued expectation on Internal Audit functions to be on the front-foot with regard to testing the design and embeddedness of the new Regimes.

The SMCR highlights the importance of governance by increasing the accountability for key individuals including presumption of responsibility for regulatory contraventions.

While the rules currently apply to banks and large investment banks regulated by the PRA, the rules represent good practice for asset managers, the UK SM&CR will be extended to all regulated financial firms by 2018. The FCA has published a policy update on duty of responsibility in relation to SMR. It sets out amendments to the Decision Procedure and Penalties manual (DEPP) which clarifies how the FCA and PRA will enforce duty of responsibility.

The FCA is consulting on extending the Senior Managers and Certification Regime to all Financial Services and Markets Act (FSMA) authorised firms.

IA Challenge

- Review the firm’s approach to ongoing identification of SMFs and Certified Individuals.
- Review high risk areas including framework, processes and underlying documentation for evidencing “reasonable steps” and handovers between Senior Managers.
- Review the status of the Certification Regime Implementation Programme and the effectiveness of related policies affecting the employee lifecycle.
- Review the extent to which the Conduct Rules have been embedded into existing conduct, recruitment, appraisals, training, HR and reward-related process by which breaches are monitored.
**Retail Banking & Capital Markets**
Banks need to ensure they are configured in a way that can support and enable Senior Managers to drive forward the business. Management need to encourage a culture of staff at all levels taking personal responsibility for their actions and make sure firms and staff clearly understand and can demonstrate where responsibility lies.

**Investment Management**
The FCA has published the final report of its Asset Management Market Study. The report proposes a series of measures which are likely to have a far-reaching impact on the industry. The measures include strengthening the duty on fund managers to act in the best interests of investors through the SMR and proposing a requirement to have at least two independent non-executive directors on the fund board.

The FCA expects asset managers’ investment governance to be robust. This should include documented processes for the governance and oversight of risk exposures across all asset classes and the entire business model, including outsourced activities and counterparty risk monitoring. Risk management practices documentation should be reviewed at least annually and updated when regulations, business models, risk appetite or processes change.

**Insurance**
PRA published proposals to extend the SMCR to insurers and proposes to:

- require insurers to annually assess and certify the fitness and propriety of employees performing functions deemed capable of causing ‘significant harm’ to the firm or its customers;
- apply the PRA’s Conduct Rules to all key function holders (KFHs) and material risk-takers at large insurers;
- require firms to notify the PRA of internal disciplinary action against individuals within scope of the SM&CR due to breaches of the Conduct Rules.

The SMR includes the ability for the PRA to approve Senior Managers in insurance firms subject to conditions and time limits. There is a statutory duty of responsibility, which will enable the PRA to hold Senior Managers in insurance firms accountable if a breach of a regulatory requirement takes place in their area of responsibility and the Senior Manager failed to take reasonable steps to prevent or stop the breach.
Competition, Innovation and Strategy
The FCA has expressed concerns that there is a lack of competition and innovation within retail banking, which could be having a detrimental effect on consumers through either product value for money or access to financial services.

Cultural change in banks to be more customer centric is not moving forward, and product changes can often be seen to be driven by profitability rather than addressing customer needs. Furthermore, the FCA is assessing the long-term sustainability of business models, particularly where firms are pursuing short-term gain to improve balance sheet such as issuing 0% credit cards.

Where niche markets are explored, the specific risks that are present within the products and/or the customer sectors are not fully assessed at a product development stage resulting in an increased risk of unfair outcomes for customers, or poor quality business being written.

For example, whilst many smaller mortgage lenders are pursuing “underserved markets” with complex affordability, they are not changing their underwriting approach to reflect the complex needs of customers to ensure they lend responsibly. This impacts both the lender’s book quality, and the outcome for the customer.

Finally, as technology innovation increases, so rises the expectation for Internal Audit to be challenging and scrutinising the technology in place to ensure it is operating effectively and delivering appropriate outcomes. This is particularly crucial where firms are using complex algorithms in decision trees as part of sales journeys.
Retail Banking
- MiFID II and FAMR will increase the focus on digital distribution, but conduct risk concerns will remain a barrier to some innovation.

- European Supervisory Authorities (ESAs) looking at big data and implications for consumer outcomes.
- Conduct implications of advice automation will be scrutinised.
- PPI remediation continues to be significant.

Capital Markets
- Firms should continue to review and assess conflicts of interest inherent when issuing capital in equity and debt markets, for example with the allocation of securities, underwriting practices, etc.

- Conflicts of interest, best execution, Market Abuse Regulation (MAR), and fixed income, currency and commodity (FICC) markets will continue to be areas of focus for firms, with new requirements in MiFID II strengthening rules on these issues in 2018, post-implementation reviews of MAR, and continued work resulting from the Fair and Effective Markets Review (FEMR).

Insurance
- Focus on the risks to the integrity of the financial markets due to deliberate accidental, misconduct by the firm and its staff.

- Under the Insurance Distribution Directive, there will be a greater focus on preventing conflicts of interest, in addition to identifying and managing them.

Investment Management
- Managers’ emphasis will remain on ensuring fair outcomes for clients in product design, distribution, execution and fee structuring.

- In addition to the considerations on conflicts of interest identification, prevention and disclosure, vertically integrated investment management firms (that provide product offerings as well as advice) should carefully examine their existing business models and ensure appropriate controls are in place.

IA Challenge
- Review the adequacy and effectiveness of the firm’s product development process to ensure it appropriately captures all risk types, and thorough analysis is conducted.

- Challenge a firm’s innovation strategy; is this driven by marketing or real customer needs? Has the full extent of regulation been considered in this area, particularly where firms are exploring ”grey areas” such as robo-advice?

- How does your firm cross subsidise their product sets? Is there a risk that too much weight is placed on volatile areas such as credit cards which see high customer attrition, and competition? Are fees set at appropriate levels?

- What governance has technology development been through? Has this been challenged by the appropriate risk and compliance representatives to ensure it meets customer needs and regulatory expectations?
Customer Vulnerability
The FCA continues its focus on customer vulnerability noting that vulnerable customers are more susceptible to harm and generally less able to advance their own interests.

Vulnerability is not set in stone, nor is it a permanent state for a customer. It can range from physical disability, mental illness, financial literacy challenges, and also age. The risk posed to firms can range from failure to set up an appropriate forbearance strategy, to inadequate advice for an elderly borrower, to failing to provide documentation in a form accessible to a visually impaired customer, or increased risks of being scammed where mental capacity is limited.

Consequently, we see Vulnerability permeating most aspects of Internal Audit activity, particularly in customer-facing or operational reviews.

IA Challenge
• How has vulnerability been factored into new and existing products? Does there need to be a change in how products are distributed and managed? Is there a framework to support this?

• How does your firm identify vulnerable customers? This is easy for high risk areas such as arrears, but what about branch interaction or correspondence by letter where key triggers may be missed? Customers, once identified, may no longer be vulnerable, and what is the process to review and move out of this where necessary? Do system capabilities allow for proper identification and record keeping to ensure appropriate management?

• How differently do we treat them? A firm may spot vulnerable customers, but the key expectation is that this information is acted upon and a different route is taken for the customer to ensure an appropriate outcome. Does the firm have set processes? Is there an exception route of governance?

• How does your firm drive consistency around vulnerability? Is there a policy? How is this cascaded, trained and monitored? Back-office functions are often less likely to recognise vulnerability as they are not always interacting directly.
Case Study – Personal Contract Purchase (PCP)

Motor Finance – FCA Review
One of the key priorities included in the FCA’s business plan (on 18 April 2017) was a review of the motor finance market. The FCA are developing their understanding of the products and sales processes, with a focus on Personal Contract Purchases (PCPs), a form of Hire Purchase, as over 90% of new car purchases are sold through this form of customer financing. The FCA made a further statement (on 31 July 2017) that highlighted the key themes of their review:

• Product affordability

• Conflicts of Interest between lenders and dealers

• Shortcomings of the Sales Process

• Risk associated with the residual value of motor vehicles for lenders

An update on the review is expected Q1 2018.

Since the FCAs announcement, the motor financing market has attracted significant media interest suggesting this may be next PPI or Derivative mis-selling investigation.

• “City watchdogs could ban ‘irresponsible’ car loans in new investigation” (The Telegraph)

• “Consumer credit has been growing rapidly…dealership car finance has seen the fastest expansion…” (BOE Financial Stability Report)

Our banking investigation & regulatory review specialists have reviewed motor financing products, their relative economics, sales practices and consumer behaviours. The shortcomings noted in the sales process were similar to those observed during the recent derivative mis-selling review carried out by our team. As a result, several possible areas of improvement were identified. Experience tells us that the FCA is likely to require a marked improvement in how motor finance is sold by finance providers. Providers may also need to prepare themselves for a regulatory review of prior sales which, can be invasive and resource consuming.

Motor financing companies should begin planning now for possible implications arising from the FCA’s review. Included in the scope of planning should be considerations such as (but not limited to):

i. assessing the potential resource impact on BAU activities should a review and redress exercise be launched;

ii. understanding whether the current governance/control framework is sufficient to meet current and new guidelines issued by the FCA; and

iii. performing a gap analysis, design and implement new governance/control framework aspects to address any identified shortcomings.

Our team have met with the FCA to discuss their ongoing review and are closely monitoring developments.
Increase Focus on Technology and Disruption

Data Analytics

Analytics can create efficiencies in the audit function through automation or drive insights to provide clear and actionable outcomes for the business.

Analytics is the application of techniques on internal and external data sources to derive an understanding of the current state of a business as well as developing a forward looking view.

The use of analytics can enhance your ability to better manage risks associated with audits. It will help to quantify the level of risk in the business and thus provide a higher level of assurance through full population testing. It will also drive the identification of other areas within Internal Audit scope through the identification of known risks.

Analytics allows for increased automation and continuity. Continuous auditing is carried out by almost a third of firms, though there is often challenge as to whether this is a service for IA to provide and this depends on the capabilities of first and second lines of defence.

A developing area is continuous risk assessment, where IA assesses potential risk in the business on an ongoing basis, and accordingly adjusts the audit plan to focus on areas of greatest risk.

IA functions are beginning to consider how they provide assurance over Big Data practices and technologies being developed by the business.

We found that the companies that use data analytics successfully get buy-in from senior stakeholders; integrate the analytics team into the Internal Audit function; invest in analytics skills and leverage analytics capabilities across the business.

IA Challenge

- Is your internal audit (and business) data analytics strategy aligned to long-term strategic goals or short-term needs? Define a clear structure and vision for the use of analytics.

- Is analytics embedded in strategic decision making? Construct a detailed roadmap and operating model covering data and technology, including culture, talent and organisational changes required.

- If you focus on building in-house internal audit (or business) analytics capability, do you risk compromising on agility?

- What are the success measures you will use to assess your investment in data analytics?

- Integrate data analytics specialists with audit teams at an early stage in audit planning.
Cyber Risk

Cyber risk has been highlighted as a focus area by a number of regulators and we expect greater supervisory scrutiny from the FCA in 2018, as the FCA is increasing its specialist knowledge in this area.

Cyber Security’s status as one the key hot topics across the industry doesn’t show any signs of abating. Regulatory interest in the ability of financial services firms to cope with rising cyber risk is heightened in the wake of the $81 million theft from the Central Bank of Bangladesh last year using the SWIFT network, and the recent Ransomware attacks. More detailed expectations are anticipated by national supervisors, while Banks and Financial Market Infrastructure firms in particular should expect increased scrutiny.

An example is the new requirement for Cyber Security from the New York Department of Financial Services which took effect in March 2017. The rules contain strict requirements for financial institutions to establish enhanced cybersecurity programmes, adopt written cybersecurity policies and procedures, and report cyber-events.

Other trends include an increased focus on cyber risk reporting at Board level. In 2016, 87% of FTSE100 annual reports highlighted cyber risk as a principal risk, however only 5% had identified a board member with cyber expertise. We expect that Boards will increasingly be under scrutiny over their practical IT and cyber expertise, and their ability to demonstrate that they can oversee and challenge management appropriately.

Responses from our survey of Heads of IT Internal Audit in 2017 highlighted that management attention and investment was becoming too focused on “overly hyped” cyber initiatives, such as threat intelligence monitoring, with a concern that traditional, operational, Information Security controls were being overlooked as a result.

Internal Audit teams and management still grapple with basic information security programmes and controls and continue to face significant challenges in areas such as infrastructure security or privileged access management, with large identity and access management or data leakage remediation programmes underway.

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IA Challenge

- Internal Audit has a role to play in ensuring that focus is maintained across the full breadth and depth of Cyber and Information Security operational controls, commensurate to the nature of the information risk exposures and risk profile of the organisation.

- Ensure the Internal Audit team is appropriately skilled and experienced to face off against stakeholders and fully understands the organisation’s cyber risk challenges.

- Internal Audit needs to enhance its understanding and readiness to assure cyber risks across new technologies that will form the technology architecture of the future, such as cloud-based, Agile systems and innovative solutions enabled by technologies such as Blockchain.
Robotics and Automation
A recent Deloitte survey on Robotic Process Automation (RPA) noted a sharp increase last year in the number of organisations that have investigated RPA, and a significant number that have already implemented or piloted RPA.

There is a clear air of transformational change on the horizon, with predictions that 35% of current jobs by 2035 will be automated. This is coupled with an unprecedented wave of wider innovation and automation spreading across the financial services industry. As operational processes are becoming more automated, the need for a robust and reliable control environment, and the ability to effectively report on the status of that environment, is ever more critical.

The terms Robotics, RPA and Artificial Intelligence are becoming prevalent across the sector. The spectrum of “automation” ranges from enabling strategies that improve parts of business processes, to implementing sophisticated technologies with cognitive elements.

RPA enables businesses to ‘take the robot out of the human’ by automating repetitive and rules-based processes to reduce cost, increase quality and boost the speed of operations. This has been very successfully applied in automating rules-based tasks such as complaints handling, know your customer processing automation and others.

What does this mean for Internal Audit and how will it impact the function and its strategic direction?

There seem to be two imminent considerations for IA: how to integrate automation in Internal Audit processes and potentially transform the function, and how to assure and evaluate risks around robotics and automation initiatives in the business. The larger FS Internal Audit functions are already considering how to deploy robotics in their operations and are including robotics audits in their plans.
IA Challenge
• Define and implement a structured approach for auditing robotics and automation in the business.

• Develop skills to understand the changing nature of the technology infrastructure and associated risks.

• Strategically consider how automation may impact, or even transform, the Audit function by being used to establish sophisticated continuous auditing and monitoring techniques or automate operational tasks.

• Reliable, available and resilient systems are critical to maintaining an edge over competitors.

Retail Banking & Capital Markets
• Resilience is critical wherever customers and regulators expect high availability of services.

• Resilient retail banking systems improve services to customers and reduce the risk of regulatory intervention.

• ECB will “strengthen” IT risk assessment methodology within SREP; EBA consulted on supervisory assessment methodology for ICT risks for banks; PRA also looking at this; EC may look at legislating.

• Cyber risk on the agenda of BoE, TSC and ECB. UK CBEST will increasingly be integrated into the supervisory process.

Insurance & Investment Management
• There is increasing pressure on insurers to widen terms and conditions to provide cover for cyber exposures. There are also a large number of policies where coverage for cyber is not specifically included or excluded. If this is not clear to the cyber policyholder, there are potential conduct risks.

• The increasing frequency of cyber-attacks leads to increased potential for aggregation of exposures. It is important that insurers monitor these against risk-appetite.

• Cyber risks bring reserving uncertainty due to lack of claims experience, historical data and market benchmarks.

• Challenges with the evaluation and monitoring of cyber reserves due to the immaturity of cyber insurance mean that reliance on standard reserving techniques is less appropriate; there is a threat of under-reserving given the continuing soft market conditions; and the risk that claims are not being notified on a timely basis to insurers due to fear of reputational damage and therefore this increases the uncertainty in reserving.
Blockchain and financial infrastructure
The next twelve months will require securing central bank and regulator support; understanding the regulatory environment; tackling governance, data security, and operational risk concerns; and improving and testing the technology, particularly in terms of scalability.

Distributed ledger technology (DLT), or Blockchain, is a technology that allows parties to transfer assets to one another in a way they can trust, through a computer network, without relying on intermediaries. Transactions are recorded in a public, tamper-proof repository organised in chronological blocks. It enables transparency, immutable records and allows autonomous execution of business rules, allowing superior automation capabilities.

There are cases for use of Blockchain in global payments, commercial property and casualty claims processing, syndicated loans, trade finance, contingent convertible bonds, automated compliance, proxy voting, asset rehypothecation, equity post-trade and many more.

However DLT isn’t a panacea. It is but one of many tools, like cognitive computing, robotics, cloud and advanced analytics. Collectively, these will shape the foundation of tomorrow’s financial services infrastructure.

However, the regulatory environment is uncertain. Standards are only just starting to be developed. Formal legal frameworks don’t exist and updating financial infrastructure through DLT will require significant time and investment. And competing interests will turn any sort of collective action into a delicate balancing act.

IA Challenge
- Educate yourself in the technology, its disruptive potential and the effect on your business.
- Work with business leadership to identify areas where DLT can present material gains.
FinTech and Disruptive Technologies

Disruptive technologies and their practical business application are at the forefront of digitalisation and innovation initiatives and are expected to revolutionise the way the financial services sector operates, trades, or services customers.

Artificial Intelligence (AI) sits at the far end of the automation spectrum (‘emerging’), and although use is still evolving in terms of organisations harnessing its full potential, AI is expected to exponentially disrupt the way firms gather information, make decisions, and even connect with stakeholders. AI automates capabilities involving intuition, judgement, creativity, persuasion, or problem-solving, by combining natural language recognition and processing, hypothesis-based predictive analysis and self-learning rules. We already see large financial services companies trialling AI in services such as analysing markets and exploring using it for buying or selling stocks at some point in the future. The focus naturally will be to reduce high-cost human resources and limit exposure to human error.

As firms seek to harness AI and advanced analytics to improve internal processes or enhance customer experience, regulators increasingly focus on the risks and unintended consequences these may bring. The Deloitte Financial Markets Regulatory Outlook 2017 publication noted that “regulatory and political support for innovation and competition will remain very high”. It is expected that while supervisors will adopt a proportional approach in their oversight of financial and technology innovation, they will also step up regulatory engagement as technologies approach a “tipping point” and gain the potential of posing a systemic risk – as the European Securities and Markets Authority (ESMA) said recently.
The advent of AI, Blockchain and crowdfunding clearly raises questions around compliance, impact on the corporate work force of the future and raises a number of risk management and ethical considerations. Internal Audit will seek to understand the inherent risks of emerging technologies, business models and innovation practices as boards will be interested in understanding, to the regulators’ satisfaction, that they have achieved the right balance between competitive position and risk – to the organisation itself, to customers and more broadly market integrity.

**IA Challenge**

- Identify skills and resources that could be aligned to business innovation hubs or other capabilities to ensure Audit can map the environment, understand risk profile and provide timely assurance.

- Stay close to industry innovation and regulators’ evolving expectations to be able to act as a trusted advisor to the business that is seeking to innovate or use ‘disruptive’ technology in a risk-aware manner.

- Understand the risks inherent in such initiatives and business models and challenge accordingly, so the approach adopted by the business takes into account interests of customers and market integrity.

- Internal Audit needs to enhance its understanding and readiness to assure cyber risks across new technologies that will form the technology architecture of the future, such as cloud-based, Agile systems and innovative solutions enabled by technologies such as Blockchain.
GDPR

Connected to the challenge of winning customers’ trust is the issue of how to collect, store, manage and use customer data securely, and firms need to ensure that they fully take into account current and future data protection regulations.

The EU General Data Protection Regulation (GDPR) will be enforceable from 25th May 2018. The new law introduces a range of requirements that have significant impact on organisations.

For global organisations, the GDPR harmonises much of the currently fragmented legal framework for privacy across Europe, providing one data protection regulation across all member states, and enhances the rights of individuals. Organisations based outside the EU that process data to offer goods and services to the EU will also be subject to GDPR requirements.

The GDPR introduces a new maximum penalty of 4% of annual global turnover that can be imposed in cases of serious non-compliance. The GDPR also mandates organisational accountability and will require organisations to implement robust privacy governance to demonstrate this. Other requirements include documented privacy risk assessments for high risk processing and data breach notification within 72 hours.

The GDPR has impact across the organisation. Legal and Compliance teams need to put in place additional governance and controls and Technology teams will have to consider privacy by design, with a focus on security.

Data management and governance teams will be challenged to provide clearer proactive oversight on data storage, journeys and lineage. Financial services organisations have to conduct data discovery exercises to determine where personal data is being processed and the legal basis for processing this data. Creating and maintaining an inventory of personal data can be challenging for such complex organisations.

Related to the inventory requirement is the need to use the inventory to provide appropriate notices to data subjects for the processing of personal data.

FS organisations often have many third party or vendor relationships and different parts of the organisation may be acting as controller or processor of personal data for third parties. Given this complexity and the number of relationships, review and renegotiation may be required on large volumes of contracts to comply with the GDPR.

Significant resources may be required within first and second lines of defence to identify high risk processing and carry out the privacy impact assessments.

This effort may be compounded by the existence of legacy systems where many FS organisations may find it nearly impossible to implement some requirements, for example, the right to be forgotten, without creating several data integrity issues.
Guidance from the Article 29 Working Party and UK Information Commissioner’s Office is still emerging, therefore understanding of what compliance looks like is still unclear and open to interpretation in some areas. Even once this guidance is issued, it’s unlikely to give organisations precise solutions on what to do given the broad nature of the regulation and also the wide audience. The proposed UK Data Protection Bill may bring in additional requirements, though it is expected to largely align with the GDPR.

**Retail Banking & Capital Markets**

- Consider how GDPR and increased supervisory scrutiny of the uses of data, particularly from conduct and operational risk perspectives, affect your firm’s ability to innovate.

  - Under the GDPR, new data privacy/protection activities are required which specifically link to compliance demands (e.g. a consumer’s ‘right to be forgotten’).

  - Some G-SIBs are now required to comply with BCBS 239, meaning that the regulatory risk is now more tangible.

**Insurance**

- The changes include an obligation to notify the Data Protection Authorities immediately, and in some cases the affected individuals, of any data breach (or potential data breach);

- There are now requirements to obtain consent through clear, unambiguous, affirmative actions – silence, pre-ticked boxes or inactivity will no longer infer consent;

- To erase an individual’s personal data and to prevent processing once it is clear that the processing is unlawful; and

- restrictions on automated decision-making including profiling where the decision-making and profiling significantly affects the data subject.

**Investment Management**

- Under the GDPR, new data privacy/protection activities are required which specifically link to compliance demands (e.g. a consumer’s ‘right to be forgotten’).

- Firms also need to consider how GDPR and increased supervisory scrutiny of the uses of data, particularly from conduct and operational risk perspectives, affect their ability to innovate. FCA and ESAs looking at big data and consumer outcomes.

**IA Challenge**

- Understand the risks surrounding implementation of new data stores and management platforms.

- Leverage both new technologies as well as the organisation’s consolidated data stores to drive more insightful and efficient Internal Audits.

- Understand the risks relating to personal data processing and monitor regulatory guidance that is emerging.

- Governance structures will be important, including appointment of a data protection officer.
Strategically Manage Prudential and Regulatory Requirements

**Financial Reporting (including IFRS)**

IFRS 15 *Revenues from contracts with customers* outlines a single comprehensive model of accounting for revenue arising from contracts with customers and supersedes current revenue recognition guidance.

The core principle is that an entity recognises revenue to reflect the transfer of goods or services, measured at an amount to which the entity expects to be entitled in exchange for those goods or services.

The new standard is effective for reporting periods beginning on or after 1 January 2017 and entities can choose to apply the Standard retrospectively or use a modified approach in the year of application. The new standard requires significantly more disclosures relating to revenue and entities will need to ensure that appropriate processes are in place to gather the information.

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**Scope**

**Step 1** Identify the contract with the customer

**Step 2** Identify the performance obligations

**Step 3** Determine the transaction price

**Step 4** Allocate the transaction price to the performance obligations

**Step 5** Recognise revenue when (or as) the entity satisfies a performance obligation
**Retail Banking**
- Consider the impacts where pricing mechanisms include variable amounts.
- Assess whether costs of obtaining a contract must be capitalised.
- Assess the extent to which distinct goods or services are supplied and account for separately.
- Challenge when up-front fees should be recognised as revenue and the appropriate accounting policies for credit card loyalty schemes.

**Insurance**
- Revenue from contracts accounted for IFRS 4 is not within the scope of IFRS 15. However, IFRS 15 will affect their non-insurance contracts as well as the non-insurance components of contracts historically considered to be insurance contracts.
- The guidance on accounting for variable consideration might change the timing of revenue recognition for non-insurance contracts issued by insurance entities.

**Investment Management**
- The impact of new guidance where pricing mechanisms include variable amounts.
- When up-front fees should be recognised as revenue.
- Whether particular costs relating to obtaining a contract must be capitalised.
Financial Reporting (including IFRS)

IFRS 16 Leases was published in January 2016 and is effective for periods beginning on or after 1 January 2019 and will replace the current standard on leases.

The new Standard brings in a new definition of a lease that will be used by lessors and lessees to identify whether a contract is, or contains, a lease.

A contract will be a lease if it enables a customer to control the use of an identified asset, by directing its use and obtaining substantially all the economic benefits for the duration of the arrangement.

For lessees, leases previously treated as operating leases will generally now be on-balance sheet. The recognition of a right-of-use asset and lease liability will lead to depreciation, generally on a straight-line basis, and interest expense, which will be front-loaded rather than the straight-line operating expense at present.

This will have an impact on reported profit and performance measures, the extent of which will depend on the size and maturity of the lessee’s lease portfolio and the elections and transitional reliefs selected.

Lessor accounting remains largely unchanged, although the new definition of a lease will capture different contracts from those historically treated as leases.

Companies should carry out an early assessment of the commercial, accounting and systems’ implications, including various elections and transitional provisions that are permitted and develop a plan for explaining this to their stakeholders.

IA Challenge

• Do you know which of your contracts are, or contain, a lease?

• Are your systems and processes capturing all the required information?

• Do you know what discount rates you will be using for your different leases?

• Have you considered the potential use of IFRS 16’s recognition exemptions and practice expedients?

• Do you know what transitional reliefs are available, and whether you will apply any of them?

• Have you planned when you will consider the tax impacts?

• Are systems and processes capable of monitoring leases and keeping track of the required ongoing assessments?
Financial Reporting (including IFRS)
IFRS 17 along with IFRS 9 will bring significant operational and implementation challenges for your organisations.

IFRS 17 priorities in next 12 months:

- Understand the overall operating model and impact of IFRS changes (Business Impact Assessment).

- Understand the impact of IFRS 17 on your profit profiles, balance sheet and income statement (Financial Impact Assessment).

- Make strategic decisions around adoption/implementation and target state.

- Complete business case and secure budget project approvals.

- Have a plan for hiring and on-boarding the right people and start to educate senior management.

- Engage implementation partners – SAP, consultants and other technology partners.

Financial Impact

- Profit-related KPIs will change.

- New measures of insurance revenue will replace the existing ones.

- Retrospective application of the Standard could have a significant impact in NAV/opening R/e on transition.

- Tax planning implications.

- Dividend distributions.
**New IFRS for Insurers: Timeline and practical implications**

- **IASB publishes IFRS 17 in May 2017**
  - Effective date 1 January 2021

- **1/2018 IFRS 9**
  - Effective date – Insurers eligible for deferral can push it to match the IFRS 17 effective date

- **IFRS 17**
  - Effective date Jan 1 2021

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**Business Impact**

- Data/policy admin systems – new data collection and storage points.
- Actuarial/Asset valuation systems.
- Accounting system changes/GL changes.
- MI/Internal reporting.
- Processes and controls/Governance.

**Strategic Impact**

- Product mix profit optimisation under new rules.
- Financial planning and forecasting will have to be adjusted for the new metrics.
- Human resources – attracting, developing and retaining the right talent.
- Selection of KPIs used for executive remuneration.
- Develop a plan to educate investors on impacts from transition to new rules.
- Investor relation communications in the post-transition period.
IFRS 9

IFRS 9 will impact your credit landscape and introduce a number of strategic and business challenges.

Owing to the increased judgement introduced under IFRS 9, external auditors and regulators are becoming increasingly interested in how financial institutions will deliver a high quality implementation of the new accounting rules.

Audit Committees are turning to Internal Audit functions to provide a level of comfort that key accounting policy interpretations and judgements are appropriate, and that all required changes to systems and processes, including data requirements and internal controls, have been identified and tested so they are appropriate for use in IFRS 9.

Given the scale and complexity of the changes required by IFRS 9, the short implementation timeframe leading up to the 2018 mandatory effective date means that it is a large, high risk project for many organisations.

The requirements of IFRS 9 will pose challenges for those responsible for the key financial reporting decisions, judgements and data collation that will support the application of IFRS 9.

The entity’s business model and the contractual cash flow characteristics associated with the financial instruments, impairment models for financial assets and risk management activities will be key areas of focus in applying IFRS 9 at transition and thereafter.

Internal Audit should ensure the correct models are applied to financial assets depending on the staging of the financial assets and assess the framework for any judgement used in the modelling process.

Data Management

IFRS 9 levies additional data gathering, capture and storage requirements on entities. Internal Audit should assess the data governance, quality and reconciliation standards for non-financial data and verify if reconciliations are performed with sufficient granularity.

IT and systems

IFRS 9 will impact different layers of the IT infrastructure. Systems and processes that entities build will need to be sufficiently automated and streamlined to deliver reliable results. IA can provide assurance whether source systems can satisfactorily record historic, current and forward-looking data sets which are required for modelling and impairment calculation data flow.
**Governance and controls**

IFRS 9 will put increased pressure on the existing governance and controls frameworks across the impairment process. Robust control frameworks will need to be designed and tested prior to go-live. Governance and controls will need to be enforced to a greater extent when comparing to standard industry practice today.

**Disclosure requirements**

Per IFRS 9, ‘Disclosures shall enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows’. The expectation is for entities to provide increasingly detailed disclosures regarding IFRS 9 approaches prior to implementation. Internal Audit can provide assurance whether existing systems have adequate “Extract, Transform and Load” capabilities.

**Retail Banking**

Retail banks will see higher and more volatile provisions, a weakening capital position, and a significantly more demanding disclosure regime with the introduction of IFRS 9. Likely increases in impairment volatility may drive up capital buffers. The number and complexity of judgements is also expected to increase. Operating margins will be further squeezed due to the need to implement system and process changes across the bank. To offset this, retail banks will be considering strategies to strengthen and protect their revenue streams through product development and realigning risk appetite and business mix.

**Capital Markets**

Funds will see a similar impact to Capital Markets; however, the scale of impact will depend on the assets within the fund and existing accounting policy treatment. Impact on fund managers will be minimal as assets are typically fair value treated so will be outside the impairment scope of IFRS 9.

**Insurance**

The accounting rules for Insurance companies without banking operations may defer implementing IFRS 9 with an expected deferral implementation date of 2021 to align with the implementation of IFRS 4 – Insurance Contracts. However, banks with insurance arms will not be able to adopt this deferral option so they will see an impact on their retail and corporate books as detailed above, and they will need to check to see that their insurance asset portfolios are considered as part of their IFRS 9 programmes.

**Investment Management**

The impact will be very similar to Retail Banking for corporate loan books. Corporate and central banks that issue financial guarantees or debt with large committed undrawn elements will see their impairment stocks rise. Issuers of debt securities will be more closely scrutinised to assess their credit worthiness. Further P&L volatility may be introduced where assets are reclassified to a fair value treatment which may result in changes to product features.

**IA Challenge**

- Assess progress against IFRS 9 programme milestones.
- Carry out a validation of build assumptions and interpretations for accounting policy, models, infrastructure, governance, and disclosures.
- Conduct periodic reviews of model validation and experienced credit judgement frameworks.
Prudential Regulations and Regulatory Compliance

**Basel IV**
The Basel Committee of Banking Supervision (BCBS) has played a pivotal role in the financial sector post-crisis reforms. The Basel III framework has increased both capital requirements and liquid asset holdings significantly since the financial crisis and the finalisation of Basel reforms continues including the Fundamental Review of the Trading Book (FRTB), further changes to the standardised and advanced approaches to credit risk, a review of the operational risk Pillar I framework, capital floors and Interest Rate Risk in the Banking Book (IRRBB) among others.

**Implementation in the European Union (EU)**
The revised BCBS principles in these areas are transposed into EU law through amendments to the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD), with the latest package of amendments referred to as CRR2 and CRDV respectively.

The updated set of requirements includes elements of the regulatory framework that have already been agreed at international level. However, some of the fundamental changes to the Basel III framework, on credit and operational risk, are still being discussed by the BCBS and hence are not included in the current EU CRR2/CRDV proposals.

The key changes proposed in the CRR2/CRD IV draft text include:

- The new market risk rules will introduce significant changes to internal model-based approaches and a revised Standardised Approach to market risk.

- 3% leverage ratio binding minimum requirement.

- Implementation of Total Loss-Absorbing Capacity as a Pillar 1 new requirement for G-SIBs with a phase-in period from 2019 to 2022.

- The Standardised Approach for Counterparty Credit Risk (SA-CCR) will replace the Mark to Market Method and remove the Standardised Method.

- Adoption of the BCBS proposed Net Stable Funding Ratio (NSFR) with some modifications.

- A lower 15% large exposure limit for G-SIB exposures to other G-SIBs and the removal of the Tier 2 capital from the calculation of the large exposure calculation.

- Disclosure rules on exposures to Interest Rate Risk in the Banking Book.

- A new 15% reduction in capital requirements for exposures to SMEs in excess of EUR 1.5 million.

- A proportionate disclosure regime that classifies firms into three categories with an additional distinction between listed and non-listed firms.

- A simplified approach to reporting requirements for small institutions, with a reduction in reporting frequency for certain data items.
Retail Banking & Capital Markets
- Capital markets firms should continue to review and assess conflicts of interest inherent when issuing capital in the equity and debt markets, for example with regard to practices associated with the allocation of securities, underwriting practices, etc.

- A number of the revised rules are likely to increase capital requirements, through an increase in Risk Weighted Assets (RWA), and financial institutions continue to deploy regulatory business, IT systems development and other critical resources for managing the implementation of these regulatory changes.

Insurance
- SII is not just about capital. Insurers are likely to expend a great deal of effort over the next few years optimising their capital positions under the new framework, as well as refining their management information and external reporting to deliver the information that both management and external stakeholders need.

Investment Management
- SII places greater data needs on insurers and asset data is no exception. Investment managers have already needed to adapt to provide insurers with the data they need to complete their reporting, and they will need to be cognisant of the fact that timeframes for the provision of data may begin to accelerate as insurers move towards end-state reporting.

- Non-systemic investment firms will be exempt from applying any modification of the CRR rules until the new regime for investment firms is in place.
EBA Enhanced Pillar 3 Disclosure requirements
The EBA’s proposed enhancements to Pillar 3 disclosure requirements introduce increased frequency (in some case quarterly) of Capital and Liquidity disclosure requirements including some fixed format templates to improve comparability and consistency. The enhanced disclosures will provide more granular breakdowns of data, with the first disclosures using the new templates required from 31 December 2017 applicable to G-SIs and O-SIs only, although the EBA may widen the scope. The proposal requires a written attestation from one or more senior officers of the bank that Pillar 3 disclosures have been prepared in accordance with board-agreed internal control processes.

Refining the PRA’s Pillar 2A capital framework – CP3/17
The consultation paper proposes to refine the Pillar 2A approach for firms using the standardised approach (SA) for credit risk. The PRA is considering the extent to which expected credit losses under IFRS 9 are already covered by the SA Pillar 1 capital requirements. The PRA is also consulting on the credit risk benchmarks which are utilised for the Pillar 2A credit risk assessment, including the use of supervisory judgement to ensure that the total amount of the Bank’s credit risk capital does not exceed the amount necessary to safeguard a sound management of risks.

ICAEW’s proposed assurance framework for reporting on banking regulatory ratios
In May 2017, the ICAEW published a technical release “Banking Capital ratios: ICAEW assurance framework”. ICAEW’s guidance provides a flexible framework for both internal and external assurance on banking regulatory ratios. This guidance:

- Does not create a requirement for assurance but rather assists those providing assurance in scoping and performing an engagement.
- Includes a proposed modular framework to provide flexibility to users and allow proportionate application to meet firm and user-specific requirements.
- Proposes a range of different formats of assurance reporting (including Internal Audit) depending upon type of work and report recipients.

The ICAEW modular assurance framework is intended for use by a variety of stakeholders, including Internal Audit, and provides:

- A matrix of key focus areas including governance, internal control, IT environment and regulatory measures output across individual components of the end-to-end production and reporting process, including Data Sources; Data Processing and Aggregation; determining calculation engine/model parameters; and Reporting and outputs.
- Organisation-wide framework principles underpinning each of these key focus areas.
- Individual modules which can be further sub-divided by risk type (e.g. credit risk) and product specifics (e.g. asset class or geography).
The PRA has not proposed any mandatory requirement for assurance, but is expected to issue a Discussion Paper during 2017 on a disclosure framework for banks’ and insurers’ regulatory data. There continues to be close regulatory scrutiny over COREP regulatory reporting submissions, including RWA (Risk Weighted Assets), capital large exposures and liquidity reporting.

**IA Challenge**

- Include a review of the newly created governance processes in the audit plan, comparing management’s process against PRA expectations.

- Use data that exists within Solvency II, alongside that for other firms which is publicly available, to identify unusual trends to focus independent challenge.

- Internal review and control processes for Pillar 3 information, which should be the same for management discussion and the analysis part of the financial report.

- Audit the firm’s programmes to manage the implementation of the new requirements and assess the status and quality of implementation ahead of regulatory deadlines.

- Review the process, controls and system architecture supporting new regulatory requirements.
Structural Reform/Banking Reform
2018 will be a significant year for banks currently working to implement the various structural reform requirements that come into force on 1 January 2019.

For a core set of UK banks there are ring-fencing requirements to meet; a much wider set of banks is also dealing with the implications of the PRA’s Operational Continuity in Resolution (OCIR) regulations. In addition, there are likely to be further resolvability activities underway within banks, such as complying with TLAC/MREL requirements and simplifying legal entity structures.

Banks will be focusing on finalising their preparations for, and then executing, a set of changes that will in many cases transform their business and operating models. Externally, the products provided by each bank, the customers they service and the entities they deal with will be restructured. Internally, this requires a major realignment across all areas, including:

- Group strategy and business plans.
- Governance.
- Control functions.
- Financial management.
- Operating models, including IT and staffing.
- Customer and counterparty management.
- Payments and FMI access.

Banks are using a special statutory process called a Ring Fence Transfer Scheme (RFTS) to transfer business between entities in order to implement the ring-fence. This is a court-based process, the hearings for which are expected to be finalised in 2018 as a precursor to implementing key steps in the ring-fence process.

Even for those banks, the OCIR requirements will require banks to map and understand their business much better; and make contractual, financial and operational changes to make the bank more resilient to a financial crisis.

IA Challenge
Internal Audit will have a role in ring-fencing and OCIR programmes to provide assurance to senior management both in respect of the programme as a whole, and the individual components within it (as these are, in themselves, major programmes to be executed). In addition, the Internal Audit function itself may require change to comply with the PRA’s expectations in a ring-fenced banking group.
HMRC Common Reporting Standard
Financial Institutions shared their first set of data with HMRC in 2017 for automatic exchange with counterparty jurisdictions. Financial Institutions are now expected to have completed all their remediation work by the end of 2017 and to report as appropriate in 2018.

HMRC has implemented the Organisation for Economic Co-operation and Development (OECD) Common Reporting Standard (CRS) and transitioned from the UK, Crown Dependencies and Overseas Territories regime (UK CDOT). The measures establish obligations for businesses including identifying which group entities are financial institutions, verifying account holders’ tax residency and reporting information on reportable persons to HMRC annually. The regulations also include provisions that can require financial institutions to notify their customers about CRS obligations, penalties and HMRC disclosure facilities.

Under CRS, reporting volumes for FS firms have grown significantly driven by an increase in counterparty jurisdictions requiring information, expansion of the Financial Institution definition and a reduction in the exemptions for account holders (e.g. removal of thresholds and regularly traded exemptions). Additional complexity has also arisen in monitoring which jurisdictions are treated as ‘participating’ under CRS. Some large jurisdictions, such as the US, are non-participating and investment entities located there may be treated as ‘passive’ with financial institutions required to look through to the underlying investors when conducting due diligence.
IA Challenge

• Review the operating model to confirm that adequate procedures are in place for CRS compliance and that sufficient resources and training are in place to support these.

• Review the governance approach and check that evidence required for tax authority audits is sufficient and adequately maintained.

• Review performance in meeting the first-year requirements and identify improvements needed to meet the increased volume of reportable information expected in the second year of CRS.

RetailBanking & Capital Markets
The CRS will have an impact on a variety of the key processes and systems of a retail bank, including:

• Master data management – via the need to include foreign indicia;

• KYC/AML and due diligence – via the need to enhance systems to capture additional data;

• Regulatory reporting – via the need to adopt a jurisdiction-specific standard reporting and information exchange-model; and

• International transaction processing – via the need to identify certain payments and certain accounts.

Insurance
The insurance sector is also likely to have the following impacts:

• Scope – under previous regimes, insurers benefited from exemptions that excluded reviewing the back-book of business; these are not available under CRS;

• Policy administration – via the need to align its policy administration system to identify products under the scope of CRS; and

• Underwriting – via the need to modify existing underwriting systems to capture the indicia information for foreign accounts.
Market Risk

The Fundamental Review of Trading Book, ‘FRTB’, will drastically change the capital requirement and risk management techniques of trading desks. With numerous new requirements and implementation costs, banks and trading firms were eager to understand the rules and examine methods to adopt their trading strategies.

The US Federal Reserve started its rate hiking cycle in late 2016 and has increased the Fed Fund rates by 50bps this year. The market has priced another 25bps rate increase for December 2017. The ECB and BOE are likely to follow suit. The change in central bank’s monetary policy has coincided with another major regulatory change for trading desks. However, both sets of these policies face uncertain futures.

To operate successfully in this environment firms will require meticulous planning including scenario analysis, different operating and desk structure planning and contingency planning. Firms need to understand how their models would behave under new monetary regime and identify the elements of the new regulation (such as PNL attribution, desk reporting and authorisation requirements) most likely in the overall FRTB regulation.

This will allow the firm to be flexible to react to any future change in scope and requirement of FRTB in future.

IA Challenge

- Assess the feasibility of FRTB plan and whether sufficient contingency planning has been undertaken.

- Review the model risk framework and models’ methodology to ensure the underlying assumptions are sound and appropriate in raising interest rate environment including Euro developments.

Retail Banking & Capital Markets

There are potential capital impacts, change in firms’ desks structures and the subsequent effects of the FRTB rules on market liquidity especially in a less accommodative macroeconomics environment. Banks their need to redesign and evaluate trading business structure.

Insurance & Investment Management

It is widely believed that the sensitivity based approach (SBA) will replace the current standard approach for market risk management. The main challenge for these firms is how to change and adopt their market risk strategy, systems and management to a risk-based approach.
Model Risk Management

A Model Risk Management Framework (MRMF) remains the key governance structure through which a firm’s risk management approach to its model inventory is structured. An effective MRMF enables active management of model risk across diverse model classes within a defined model risk appetite as set by the board.

The MRMF ensures a consistent approach to risk management and promotes a sound risk culture across an organisation’s diverse model owners and users underpinning day-to-day business decision-making. Model Risk Management remains a hot topic for UK and global regulators especially given the ECB review of Banking Internal Models. We are increasingly seeing the active adoption of the US FED principles for an effective MRM framework (2011) as the emerging standard in model risk management activities.

Putting this into practice through MRMF monitoring and reporting demonstrates the depth of the MRM and enables early identification of potential model risks thereby allowing the firm to react in a timely manner and deploy credible management actions.
New approaches | 2018 Planning Priorities for Internal Audit in Financial Services

- Increased operational and process efficiency in model development and validation.
- Optimised and automated key modelling processes allowing the elimination of defective models.
- Alignment with organisation-wide model risk appetite.
- Base investments in models on model risk appetite limits.
- Aligning resources with organisation-wide model priorities.
- Predefined processes, tools, and optimised resource management.
- Regular communication across all lines of defence ensures cohesion and common understanding.
- Standardised reporting and continuous monitoring.
- Transparent reports up to the management board.

- Reduction of undue capital buffers and add-ons by more focused model resource deployment.
- More effective management of excessive conservatism.
- Control over fragmented model ownership and processes.
- More model transparency.
- Creates an institutional risk culture.
- Material model classes will have specific tailored MRM procedures.
- Improving insights based on factors such as model health, materiality, resource efficiency and model size.
- Facilitates alignment of common goals and priorities throughout the model life cycle.
Retail Banking & Capital Markets

Retail Banking and Capital Markets firms are facing pressure from a range of stakeholders including the ECB to ensure that the MRMF is fully embedded and integrated across the organisation, is actively applied through the wider model inventory and is seen as strategic in terms of governance and business processes and day-to-day business operations.

Areas of focus include a bottom-up review of model risk management capabilities across the credit risk lifecycle to ensure alignment to board validation requirements pertaining to credit risk.

Firms are also struggling with working through the appropriate governance level at which the MRMF is articulated across different model classes and monitored for actual model process risks and the link to key mitigating controls.

Firms are expected to enhance MRM frameworks to improve overall governance of models as the expansion of core models increases due to regulatory developments such as IFRS9.

Insurance & Investment Management

Investment Management and Insurance firms increasingly focus on model-related risks in achieving their business strategy and objectives. There is a heightened expectation among non-executive directors of Investment Management and Insurance firms for more effective use of MRM as a mechanism to manage and control risk. Boards are increasingly seeking to embed more effective model management to support monitoring of the key strategic risks against the risk appetite statement and to achieving the business strategy and objectives.

Investment Management and Insurance firms are increasingly drawing upon developments and insights in other financial services industries to inform the treatment of model risk and its categorisation within the wider risk framework. For example, there is an increasing recognition of the need to establish quantitative methods for model risk to produce key performance metrics.
IA Challenge

- Review the design and operating effectiveness of key controls for the independent effective challenge of models, including the depth and quality of technical challenge offered by the validation function in their assessment of model conceptual design and associated conclusions regarding performance monitoring.

- Where critical modelling activities are undertaken by third parties ensure that sufficient oversight exists to provide assurance that key MRMF requirements are being met.

- Review the existence of model risk identification processes.

- Review the design of current controls against the major risks across key capital, pricing and business planning models.

- Review the appropriateness of risk appetite limits in relation to model risk.

- Review the completeness of the model inventory and assess the risk ranking methodologies applied for robustness.

- Assess current model risk capabilities, documentation and processes relative to regulatory expectations and observed market practice.

- Assess evidence demonstrating the breadth and depth of the MRMF in practice across key business models.
Credit Risk

Intensified regulatory requirements, increasing uncertainty of the economic environment and the continuous pursuit of competitive advantage have kept credit risk management at the top of the financial services agenda.

The emergence of new technologies such as intelligent automation and robotics have been a source of productivity gain for credit processes, but they also require new skill sets within the bank to ensure their design aligns with risk management fundamentals and risk appetite.

The changing environment and new technologies pose new challenges for credit managers with a fast change of portfolio credit profile (e.g. driverless cars leading to unemployment of taxi drivers), necessitating proactive mitigation plans.

Audit Committees are turning to Internal Audit functions to confirm that new processes, credit policy adjustments and modelling advancements are appropriate and adequately controlled. They require assurance that guiding strategic principles are followed and have been consistently implemented in systems, processes, skillsets and resources.

Effective and efficient credit risk management includes:

- **Risk Strategy** – set the types and level of risk your business is willing to accept to meet strategic objectives and create an auditable trail of management responses to its execution.
• Credit Processes – business processes should respond to the risk strategy with consistent embedding of risk parameters and principles within the bank (such as risk-based pricing, IFRS 9 link to underwriting parameters).

• Automation and Cognitive Intelligence – technology can provide solutions to significantly increase efficiency, speed and reliability of key processes such as underwriting, collections and reporting. These technological developments pose fresh audit challenges in assessing the adequacy of decisions.

• Risk Measurement & Reports – regulatory reports (RWA, Ecap, Stress Testing), impairment estimates (IFRS 9) and internal risk reports may influence the decisions made by management, and will also be reviewed by regulators, government bodies, analysts, investors and ratings agencies. Design and implementation is essential to ensuring effective risk-aware decision-making and to maintaining credibility with external stakeholders.

• Governance Framework – the target operating model enables efficient and effective delivery and execution of the bank’s strategy. Policies, processes, systems, resources and skillsets should be aligned to the chosen operating model and ensure its operational implementation and functioning.

IA Challenge
• Confirm that management have appropriate and robust oversight controls in place around affordability and creditworthiness that include a structured plan to check that risk escalations reach senior management on a timely basis.

• Review the consistency of Risk Strategy, Risk Framework and Risk Policies and ensure the consistency of end-to-end risk processes.

• Assess the control framework to identify risks associated with complex algorithms, automation and cognitive intelligence.

• Carry out a review of risk models to ensure regulatory and accounting policy compliance.

• Assess the output of risk models to ensure quantification techniques are appropriately implemented.
Corporate Criminal Offences

The Government has introduced new Corporate Criminal Offences for Failing to Prevent the Facilitation of Tax Evasion.

The rules require businesses to implement and maintain controls that are reasonably intended to prevent their associated persons assisting in tax evasion. Whilst this is primarily a UK measure, the powers are widely drawn, making UK and non-UK corporates and partnerships liable for facilitating the evasion of tax, globally.

Penalties for non-compliance are expected to include significant monetary fines, and action under the new rules would expose an organisation and its senior individuals to significant reputational risk.

The Corporate Criminal Offence follows a broad principles-based approach and seeks to build on existing control environments. HMRC has confirmed that there will be a transitional period for implementation, but all companies and partnerships are expected to take significant steps ahead of 30 September 2017.

Note that many businesses may already be on the path to compliance through previous Anti Bribery and Corruption work.

Retail Banking
Retail banks should incorporate an ongoing monitoring into their existing cycle of regulatory change and understand which employees and intermediaries fall within the scope of the requirements. Risk assessments will take careful planning so that the response is proportionate.

Capital Markets and Insurance
Where intermediaries are used to distribute products, this will add a new layer of due diligence.

Investment Management
Identifying the associated persons of an Investment Manager and introducing controls may pose a challenge, especially where these include third party administrators.

IA Challenge

- Ensure compliance projects leverage existing governance structure and risk assessment processes.
- Plan for a post-implementation review of the new controls and processes.
- Carry out a project management audit of the firm’s programme to manage the implementation of the requirement.
- Implement change and evidence a culture of compliance which is driven from the top down.
- Undertaking due diligence on associated persons.
- Introduce communication and training on this offence.
Brexit Effect on 3 Lines of Defence
The terms of access which the UK negotiates to the Single Market will be fundamental to future strategy and business models.

The national and international focus on Brexit will ramp up even further through 2018, requiring clear actions plans from banks' management and with strong demands for information from regulators, clients and investors. Banks will go into 2018 with a set of expectations of how they expect the process may play out and their responses to those different scenarios, which will need continuous assessment as the shape of the final arrangements emerge in the run up to the two-year deadline in March 2019.

In addition the banks undertaking their own internal planning, the degree of regulatory scrutiny will of course increase markedly as well. In the UK, the PRA has required all of the banks, insurers and designated investment firms for which it is responsible to submit their plans for dealing with Brexit. They have indicated that their assessment of the 401 responses received are in the process of being assessed for what it says about each firm's individual plan as well as the wider financial stability impact of the plans collectively. The Prudential Regulation Committee and the Financial Policy Committee are expected to take views on this in autumn 2017. It seems likely that these deliberations may in turn trigger a further round of supervisory requests going into early 2018. In addition, banks' management will need to engage with and take account of the evolution of the supervisory expectations of the ECB and individual national regulators.

The key impact on banks' business model is the ability of a UK entity to serve EU clients and vice versa, the ability of a EU entity to serve UK clients. Most banks already have selected a preferred structure for maintaining market access under an expected 'Hard Brexit' with applications already submitted to regulators in many cases. Many banks have programmes in-flight to submit regulatory license applications, make the changes required to their business and evidence this to their prospective regulator(s).

As banks seek to establish new entities or 'ramp up' existing ones, key activities that they will need to perform over the period between now and the day of Brexit will include:

- Establishing governance and control functions
- Determining the service model of each entity, including controls over the outsourcing of functions carried out in London (in particular front office roles which will require comprehensively defined control frameworks)
- Developing an appropriate booking model, in particular where the EU27 entity will on day 1 will expect to rely on ‘risk transfer’ to the UK entity (under the so called ‘back-to-back’ model) and will have to show alternative arrangements are in place, whilst setting out a path to undertaking trading in financial products on a full risk taking basis.
• Ensuring connectivity of both the UK and EU27 entity to the required Financial Market Infrastructure (including across clearing houses, exchanges, trading venues and platforms, custodians, securities depositories and payments infrastructure)

• Preparing required documentation, putting in place the required local risk governance and ultimately obtaining approvals for the following models (IRB, IMM, IMA) that may be required

• Creating a transition plan in particular for changes in the post day 1 business model, as alluded to by the ECB in recent speeches

Retail Banking
• Increased commercial and regulatory headwinds.

• Banks continuing to analyse relationship between legal and substantive presence to determine locational strategy.

• Expect an uptick in Brexit-related work once Article 50 triggered.

• Oversight by supervisors will gather pace as their planning evolves. For IBs there will be particular scrutiny of booking models.

Capital Markets
• Economies of scale at risk.

• Capital markets union project benefits at risk.

• UK loses influence over future direction of capital markets.

• Loss of passporting and access rights under EU legislation, such as MiFID II and EMIR, will have implications for how UK firms provide investment services to EU clients and how EU clients access UK market infrastructure (e.g. trading venues and CCPs) and vice versa.

Insurance
• IDD does not include third-country provisions. Firms will need to provide services via EU distributors. Solvency II has no third-country passporting provision. Non-EEA insurers will have to establish a branch in a Member State to continue offering services in the EU. GIs without locally regulated branches or subsidiaries will be most significantly affected. UK life insurers will have fewer passporting issues, due to existing subsidiaries, and their focus on growth in Asia and the US. Equivalence is not comprehensive under Solvency II, only applying to reinsurance, group supervision and solvency calculations.

Investment Management
• Prioritise addressing perceptions of investors and their financial advisors.

• Depending on the terms of the deal negotiated with the EU, firms could see a different regulatory regime in the UK from the EU and the loss of EU passports. Access via an equivalence assessment is not available for services to retail investors, and may be granted for services to non-retail investors under MiFID II and AIFMD.

• Contingency plans need to consider implications for access to clients, trading venues, clearing and custody services.

IA Challenge
• Assess whether sufficient contingency planning has been undertaken.

• Consider Brexit in the annual audit planning and ensure that there are adequate resources available to deal with any immediate issues, remaining flexible to business needs.
Enhance the Structure and Capabilities of Risk Management

Risk Management Framework
The drivers for embedding risk management frameworks are increasing regulatory pressures, reduced operational loss exposures (such as fines and remediation costs from compliance breaches) and increasing competitive advantages deriving from informed management decisions.

A risk management framework is embedded when the organisation is risk-intelligent and everyone understands the organisation’s approach to managing risk, takes personal responsibility to manage risk, and encourages others to follow their example.

The regulatory and business environments have become more volatile and unpredictable and therefore institutions should increase focus on strategic risk; enhance risk management capabilities; and rethink the three lines of defence and risk alignment.

There is an opportunity to take risk management to an entirely new level that truly provides the capabilities to support the organisation’s strategic plan by considering the IA challenge.

Investment Management
Whilst pure IM firms are not in scope for BCBS 239 compliance, the largest players have started targeting compliance with the principles, understanding the benefits and the positive developments arising from better risk data quality and improved risk management.

IA Challenge
• Infuse risk management into strategy.
• Leverage emergent technologies.
• Consider in the case of non-compliance at the implementation deadline, the robustness of remedial plans and the extent to which these are agreeable to supervisors.
• Carry out a project management audit of the firm’s programme to manage the implementation of the requirement to assess the speed and quality of the improvement in architecture and processes.

Retail Banking & Capital Markets
Whilst virtually all G-SIBs are active in these sectors, covering the mandated risk types (market, credit, liquidity and operational), it is likely that an ever-larger population of regional players (D-SIBs) will be progressively requested to comply with the principles.

Insurance
The insurance industry has been excluded at inception from the scope of BCBS 239. However, regulators in some countries (Canada being the prominent example) have requested the largest firms in the sector to align themselves to the standards required to G-SIBs.
Risk Appetite Frameworks

An effective Risk Appetite Framework (RAF) enables proactive management of the risk profile within the defined risk appetite as set by the board.

The RAF is one of the key mechanisms to ensure a consistent approach to risk management and to promote a sound risk culture across the organisation for day-to-day business decision-making. We are increasingly seeing the active adoption of the Financial Stability Board’s principles for an effective RAF (2013) as a standard in executive roles and responsibilities and risk management activities. The board should ensure the RAF articulates measurable statements of risk appetite to support delivery of the business strategy and objectives.

Putting this into practice through risk appetite monitoring and reporting demonstrates the depth of the RAF and enables early identification of potential breaches of approved limits, thereby allowing the firm to react in a timely manner and deploy credible management actions.

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Non-financial risks should receive greater prominence in the RAF pertaining to key performance metrics such as profitability.

IA Challenge

- Assess the RAF’s breadth for financial and non-financial risks.
- Ensure the RAF has appropriate governance and ownership, and forms an integral part of the firm’s business decision-making across all levels of the hierarchy.
- Draw on external expertise of risk appetite to undertake a benchmarking review of current and target state activities for the RAF design and implementation.

Retail Banking & Capital Markets

- Ensure that the RAF is fully embedded and integrated in the wider RMF, as well as strategic planning processes and day-to-day business operations.
- Focus on a bottom-up review of risk management capabilities across the credit risk lifecycle to ensure alignment to board risk appetite for credit risk.
- Challenge the appropriate governing level at which risk appetite is articulated and monitored for cyber, conduct/regulatory and model risk, and the level of reporting at each level.
- Firms are expected to utilise risk appetite monitoring and reporting to support strategic decision-making.
- There is a heightened expectation among non-executive directors for more effective use of risk appetite as a mechanism to manage and control risk. Boards are increasingly seeking to embed more effective risk appetite limit setting and reporting to support monitoring of the key strategic risks against the risk appetite statement and to achieving the business strategy.

Insurance & Investment Management

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Insurance & Investment Management
Financial Crime and AML
From a UK regulatory perspective, the FCA’s unrelenting focus on financial crime continues, particularly in relation to AML, as reiterated by its Business Plan (2016-17), which references AML as the FCA’s second highest of seven priorities for the coming year.

Firms have been strongly encouraged to conduct assessments of the risks posed by their customers and institute sophisticated systems and controls which prevent financial crime. 2017 saw a suite of changes to the financial crime landscape in the UK. Against a backdrop of the Fourth Money Laundering Directive being finalised in 2015; the Panama Papers scandal and the UK’s commitments on corporate and tax transparency in 2016; and the outcome of the Government’s examination of the anti-money laundering reporting framework (also in 2016), 2017 bore the fruits of new standards and criminal offences.

First to the table was the Criminal Finances Act 2017. Passed swiftly in the period before Parliament was prorogued for the General Election, it changed the landscape for reporting entities through the creation of unexplained wealth orders, allowing the co-ordination of Suspicious Activity Reports between institutions, and allowing the extension of the moratorium period for consent to act when a Suspicious Activity Report has been made. It also brought into law two corporate offences of failing to prevent the facilitation of tax evasion (one in relation to UK taxes, and one in relation to non-UK taxes).

As of 30 September 2017 companies and partnerships must have reasonable procedures to prevent the facilitation of evasion of these taxes by their employees and other associated persons.

The Government guidance sets out six principles for companies and partnerships to follow in establishing their reasonable procedures, including risk assessment, training, and monitoring of compliance with procedures.

No sooner had Parliament returned after the General Election than the Statutory Instrument implementing the Fourth Money Laundering Directive (the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) 2017) was laid, coming into force only four days later on 26 June 2017. Some of the key changes made are: to the definition of Politically Exposed Persons; greater detail on the meaning of beneficial ownership; a renewed and extended emphasis and detail on risk assessment; a broader definition of correspondent relationship and removal of the automatic application of simplified due diligence for certain types of customer.
Retail Banking
- Retail banks are encouraged to have appropriate AML tools and technology in place to provide the functionality.

  • Consider all of the new changes, particularly the extension of the definition of Politically Exposed Person to include domestic as well as foreign ones. Retail Banks may find they have larger populations of this type of customer than they would expect.

Capital Markets
- The key issue is generated by the broader definition of correspondent relationship, beyond the traditional “nistro-vostro” set-up. The response will require a carefully thought out analysis of the financial crime risk in these types of customer.

  • Define and document a risk-based approach, clearly showing the risks to which the business is exposed and how those risks are reflected in risk appetite, policies, procedures and controls.

Insurance
- An ‘Annual Financial Crime Report’ to be submitted by large general insurance intermediary firms.

  • This requirement has forced the insurance sector to seriously consider the allocation of suitable resources to manage financial crime risks.

  • Insurance business, particularly that with an investment element, has vulnerabilities to money laundering but these vary widely depending on the product sold (and even between similar products). The emphasis on risk assessment in both the Criminal Finances Act and the new Regulations indicates that insurance businesses must conduct a careful risk assessment and be able to articulate in a clear and detailed manner the reasons why their business carries the risk they have determined, and what the resultant control framework looks like.

Investment Management
- There is an opportunity to leverage them for enhancing AML systems and controls.

  • New detail on the definition of beneficial owner will make customer due diligence more challenging for Investment Management businesses and the businesses they work with.

  • Undertake a robust risk assessment, and define and document their response to those risks.

IA Challenge
- Consider the implementation of the governance framework and confirmation that the firm has placed suitably skilled resources in key business areas, aimed at embedding a culture which prevents financial crime.

  • Review the steps taken in response to the new legislation, particularly in response to the Criminal Finances Act 2017. The response may be UK only, or may be global, depending on the policy decisions taken by management.

  • A focus on the quality of the underlying documentation for evidencing compliance is a vital step and a point which will set the good firms apart from the bad.
Risk-adjusted pricing and performance management

Uncertainties over the global economic outlook and residual loose-ends in regulatory capital frameworks have prompted a wider rediscovery of internal capital models (e.g. Economic Capital) for banks, investment managers and insurers. The new IFRS 9 accounting policy with effect from January 2018 poses significant implications to banks’ lending strategies, with the incumbent Risk-adjusted pricing (RAROC) models and performance management (RAPM) frameworks subject to review and challenge.

Those with outdated internal capital models and pricing approaches are running a serious risk of bringing unwanted volatilities into their books. If capital allocation and business profitability is not risk-adjusted through a well-calibrated framework, the efforts to embed a long-standing risk culture may result a less fruitful outcome.

Retail Banking
- Retail banking firms should pay close attention to Accounting changes i.e. IFRS 9 or CECL if relevant; and a potentially revolutionary change of the incumbent banking model – Open Banking (PSD2).

- IFRS 9 introduces a new set of accounting policies, where the changes in impairment measures, and subsequent capital implications, are likely to cause banks to need to reposition their targeted clients and markets.

- PSD2 is mandated by the Competition and Market Authority in the UK to unlock the digital value chain, which in response will push banks to seek new client opportunities and improve customer experience. The two strategic challenges ahead point to a need for retail banks to integrate regulatory changes, and disruptive market dynamics, into a new generation of RAROC, RAPM frameworks.
Capital Markets
• With greater uncertainties and risks in the market, the scale of the challenge for investment management is expected to increase. Debt investors are likely to re-assess the fair value of invested assets under the new accounting regime, adjusting and balancing the portfolio mix towards their risk appetite.

• Equity investors seek compensation for market volatilities, and potentially will re-evaluate the risk-adjusted economic value of invested assets.

Insurance
• Since the crisis, capital markets globally have firmed their position on risk-based security pricing strategies and performance measurements. ROE remains a key strategic challenge for this sector, which drives heavy discussions and debates of capital usage effectiveness in the FRTB context.

Investment Management
• Insurers have a long history of applying RAPM frameworks into product design, underwriting and business performance management – with cognitive technology prevalence, are those frameworks and strategies still relevant, and responsive to the market?

IA Challenge
• Review the firm’s ECAP/ Pillar 2 capital frameworks, models, and parameterisations and ensure they are aligned with the up-to-date regulatory guidance.

• Review the firm’s RAROC pricing model and assess its consistency with the upstream model inputs, in particular IFRS 9 impairment, to ensure granular inputs are appropriately applied.

• Assess the embedding of the pricing models within the firm’s first line of defence.

• Examine and check whether the firm’s current business performance measurement processes have adapted, or established actionable plans in response to the latest regulatory changes (e.g. IFRS 9, TLAC).
Operational Resilience
Organisations are facing increasing amounts of uncertainty and disruption, bringing both risks and opportunities, which more resilient organisations are better prepared to overcome and gain from.

Financial Resilience
Following the BCBS's conclusion of most of its work on the risk framework early in 2017, the EU will deliberate how to adopt the new capital standards, while protecting the region’s economic priorities. Banks will have to deal with uncertainty over the final shape of the rules as well as enhanced balance sheet management capabilities for TLAC, MREL and IFRS 9 implementation.

Cyber and IT Resilience
Spurred by a number of high-profile attacks on firms, supervisors will increase their focus on cyber resilience. Supervisory expectations will include more detailed planning for responses to scenarios such as cyber breaches and technological failures. Firms will increasingly use testing, war-gaming and red team exercises to demonstrate the robustness of their resilience plans.

For firms, this means a greater alignment and integration of ‘protective disciplines’ so that they directly and collectively contribute to the protection of customer service. There should be a collective focus on identifying and preparing for one-off, high-impact events, as well as ensuring continuity of service in day-to-day operations in the face of potentially disruptive events.

IA Challenge
- Assess whether the scope of risks or scenarios addressed under crisis management and resilience are appropriate.
- Challenge the robustness of resilience to/planning for major disruption and catastrophic risks including the time horizon considered.
- Ensure adequate coverage across the change portfolio and a timely audit effort that can deliver valuable, impactful, recommendations whilst minimising disruption to programme resources.
- Enhance training on Agile methodologies or toolsets to enable a constructive engagement and strong focus on risk.
Agile Internal Audit

The overarching theme for most Internal Audit groups is the need to change. An Agile Internal Audit approach provides methods that work to change both the mindset of Internal Auditors and their work processes.

Agile Internal Audit is the mindset an Internal Audit function will adopt to focus on stakeholder needs, accelerate audit cycles, drive timely insights, reduce wasted effort, and generate less documentation. Agile prompts Internal Auditors and stakeholders to determine, up-front, the value to be delivered by an audit or project. What level of assurance is needed? What risks are most concerning?

An Agile Internal Audit approach can enable Internal Auditors to respond quickly and effectively as strategies, priorities, technologies, regulations, and risks evolve. Agile Internal Audit methods work to shift Internal Auditors’ mindsets and processes by pursuing:

- Clearer outcomes. Rather than, for example, open-ended reviews or audits in search of findings, Agile Internal Audit methods aim to confirm or disprove a hypothesis or support a point of view. That way, the audit or project targets an outcome, which guides the fieldwork and reporting.

- Increased engagement. While maintaining objectivity, Internal Auditors – in collaboration with stakeholders – prioritise areas, issues, and risks. This helps them identify needed resources and focus their work on factors that determine business performance and value.

- Improved documentation. Instead of feeling the need to explain every step taken and justify it through exhaustive documentation, agile Internal Audit frameworks can deliver briefer, timelier reports with fewer words and more visuals.

Agile Internal Audit frameworks drive improved results through four transformative changes:

- Enhanced Internal Audit planning. Rather than rigid Internal Audit plans, Agile Internal Audit planning maintains a continually updated backlog of audits and projects to be undertaken when the goals are clear and resources are in place.

- Empowered Internal Audit teams. Upon providing interim reports, the team and stakeholders can determine whether greater assurance or higher quality is needed. If it is needed, the work continues; if not, it ends. These decisions can be made at lower levels because senior people have established parameters and teams have clear guidelines.

Agile Internal Audit

New approaches | 2018 Planning Priorities for Internal Audit in Financial Services

- Accelerated delivery cycles. Internal Auditors work within time-boxed sprints to complete a set of well-defined tasks. Sprints set a faster cadence for audits and projects by setting out to provide a level of assurance or to confirm a hypothesis rather than document activities.

- Valuable insights. By streamlining the work and documentation, Agile Internal Audit frameworks focus Internal Auditors’ attention on the trends, risks, challenges, and opportunities that can most impact the organisation and drive insights.

Our IA Agile Manifesto to Elevate Internal Audit

1. Outcome-driven and Value-driven.
2. Just-in-time. Proactive approach to the “right projects at the right depth/focus”.
3. One size does not fit all. Customised project focused on value and risk.
4. Collaborative approach – take the journey with our clients.
5. Mix it up a little bit, break some eggs – challenge “that’s the way we’ve always done it”.
6. Decisions “as you go” with transparency and alignment.
7. Continuous communication with all stakeholders.
8. Be quick and iterative versus continue to a plan.
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