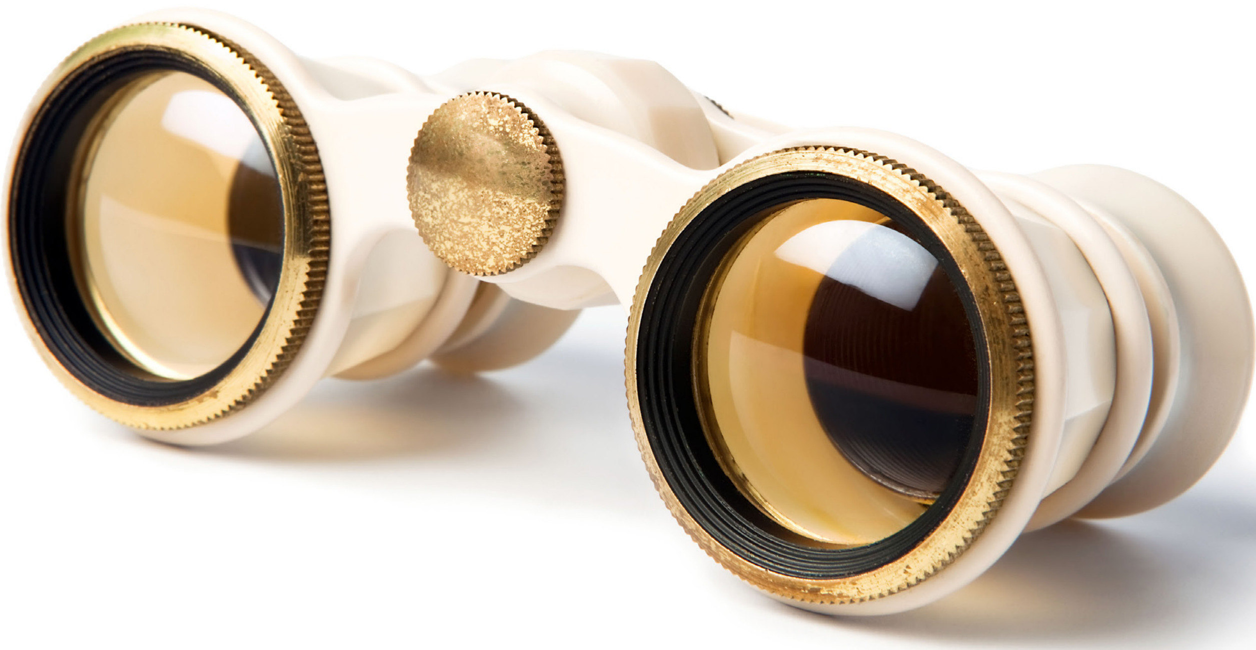
Looking ahead
2014 Hot topics for internal audit in financial services



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Key hot topics for 2014

The role of internal auditors in financial services continues to gain importance. Internal audit teams are expected to be highly influential and visible in providing effective assurance across high risk areas in their organisations. This year, a number of emerging topics have taken centre stage for the financial services industry. Internal audit functions will need to have considered their approach to these matters and to demonstrate coverage of a number of sensitive and ambiguous topics.

1. Business leadership
- Governance
- Culture

2. Risk management
- Risk frameworks
- Risk appetite
- Risk data aggregation
- Model risk management
- Third-party risk management

3. Regulatory matters
- Conduct risk
- Financial crime
- Client assets
- Regulatory reporting

4. Capital and liquidity
- Liquidity management
- Risk weighted assets

5. Trading
- Indices and benchmarks
- Unauthorised trading
- High frequency trading

6. IT
- Data analytics
- Payment services
- Cyber crime
- Data governance and quality

7. Accounting and tax
- Tax risk management
- Loan loss provisioning

1. Business leadership

Since the financial crisis, there has been intense scrutiny over the **governance of financial institutions** from regulators, investors and within organisations themselves. Many audit committees and executives now expect that internal audit will assess governance and culture as part of their mandate and plans. For many internal audit functions this will be a new area within their audit universe, whilst for others now is the time to take stock and enhance their existing approach. The focus of governance audits is shifting from testing compliance with codes and regulations, to assessing the impact of governance activities in practice and whether the impact of new regulations has been communicated to first line employees and embedded into processes and systems. There are a number of emerging trends and market focus areas in governance, for example increasing individual accountability and clarifying delegated authorities. Internal audit functions will need to confirm their approach and toolkit is kept up to date with emerging practice in order to effectively challenge the status quo and governance outcomes in their own organisations.

Culture has emerged as one of the fundamental issues under the microscope as policy makers, regulators and senior management in financial institutions seek to address what is perceived to be a root cause of the financial crisis. This is a complex topic and will pose many challenges as driving a real change in culture cannot be achieved swiftly, yet this plays a vital part in restoring trust in the financial services industry. Organisations will need to move towards clearly stated values, with reinforcing incentive structures and delivering a culture that promotes the desired outcomes. This new focus on culture and behaviour in financial institutions demands that internal audit evaluate the "tone from the top" and begin to apply a culture lens to their audits.

2. Risk management

Risk appetite and its benefits have come to the fore in financial services organisations with numerous case studies of failed firms whose ineffective risk appetite frameworks played a part in their downfall. Internal audit can assist the board in providing an independent assessment of the design and effectiveness of the risk appetite framework, its embeddedness and alignment with supervisory expectations. When firms are criticised for shortcomings in their risk governance and management an appetite framework is commonly prescribed as a cure by regulators. Internal audit should assess whether the risk appetite framework has been properly established, embedded and enforced.

Many organisations have recognised the need for good **operational risk management frameworks** with increasing demands from regulators and senior executives that controls are embedded in the business and delivering value. Internal audit has a role to play in ensuring operational risk management frameworks are not just focused on the framework design, but also on the clear governance, roles and responsibilities, training and awareness required for implementing and embedding them effectively. A well-defined and widely utilised operational risk appetite is a key tool for aligning perceived 'front office' activities with the organisation's attitude to risk.

Organisations also continue to grapple with the challenge of concise but robust, high quality **risk data aggregation**, ensuring swift escalation of issues to the board, rebalancing the board agenda between strategic and regulatory matters and addressing the increasing demands on non-executive director time. There has been an increase in the quantity and quality of data required for regulatory and other external reporting purposes and internal audit should naturally evaluate the quality of this data and the overall effectiveness of data governance.

Organisations often rely on outsourced parties to deliver support to critical functions of their business. Whilst these activities are outsourced, the responsibility for the activities still lies with the organisation and therefore requires robust oversight. Internal audit is required to assess the effectiveness of firms' approach to third-party risk management and assurance frameworks over outsourced activities. A number of Australian firms have suffered reputational damage alongside significant outlays due to failures resulting from failures by third-party providers. As a result, it is imperative for organisations to have a comprehensive approach to **third-party risk management**.

Models have become an integral part of the operating environment for most financial institutions. However, models are only an estimate of reality. They carry varying degrees of uncertainty which increases with the level of sophistication and complexity of the model. Internal audit should have a framework for providing assurance over modelling governance and management, including having access to the quantitative skills for assessing models themselves. High profile cases of model failures have led some regulators to add a discretionary model risk charge to the capital requirements of most institutions. Owing to the reputational and financial implications associated with **model risk management** – identification, measurement and mitigation of model risk have gained considerable attention recently.

3. Regulatory matters

Many financial services organisations have been hoping for a reprieve from the extent and breadth of regulatory change introduced over the past few years. Unfortunately, the 2014 regulatory change agenda is as busy as ever with key implementation milestones for FATCA and OTC reforms coming through, as well as the on-going super reform requirements and amendments to FOFA, to name a few.

Internal audit (together with specialist support) will continue to play a key role in validating the design and operation of the controls required to confirm compliance with the new requirements or standards. In addition, internal audit teams will need to confirm that the scope and type of assessment is prudent for the organisation in question, which will include factoring in new or proposed regulatory requirements.

Australia is expecting its review from the Financial Action Task Force (FATF) which will see significant changes to the way customers are on-boarded and managed through customer due diligence (CDD). There is increased regional complexity stemming from the regional and super regional strategies of organisations. Regional regulators have augmented their vigilance related to tax evasion, rate setting and market manipulation.

New services and channels continue to promote multi-channel fraud. Australian measures for multi-factor authentication and payment management remain behind the global benchmark of innovation, adoption and deployment. The extraterritorial business is creating concern about the ability to manage an expansionist book alongside the regional threat of bribery and corruption. Several significant initiatives to mitigate this threat have been launched by Australian institutions.

Globally, we are seeing the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) maintaining a forceful approach as noted by recent fines for anti-money laundering (AML) failings of a number of organisations. The failings have highlighted a number of weaknesses in firms, especially in relation to customer due diligence on high risk customers. With the impending introduction of the fourth EU Money Laundering Directive – internal audit is expected to have the necessary skills and experience to assess whether their organisation's policies, procedures and systems are geared to confirm adherence to more comprehensive AML requirements. Sanctions imposed by the UK, EU, US and United Nations are another area where financial institutions have been criticised for a lack of appropriate systems and controls.

Organisations are expected to have adequate arrangements over client monies and property in areas such as management processes, bank account arrangements, treatment of collateral, completeness and accuracy of the client money reconciliations, oversight of outsourced providers and sufficient management information and reporting. Internal audit should be actively involved in providing assurance over these areas. Documentation over these areas is expected to be fully compliant with the client money and property rules and there should be adequate second and third line of defence monitoring programs, including internal audit, to validate the design and operation of controls as well as specialist skills to implement and monitor the client money and property rules.

Financial institutions – and indeed internal audit functions themselves – are experiencing a step change in the quantity and granularity of regulatory reporting requirements as a result of the implementation of Common Reporting Framework (COREP) and Financial Reporting (FINREP) in 2014, together with a range of other new reporting obligations and an increasing number of firm specific and/or peer group data requests from regulators. Internal audit can assist senior management in demonstrating robust challenge and oversight over regulatory reporting, and to satisfy themselves that a comprehensive control framework surrounding the new data requirements has been effectively implemented. The accuracy of capital, liquidity and other prudential returns is increasingly being challenged as a result of peer group review.

4. Capital and liquidity

Robust funding strategies, daily liquidity management and forecasting remain key business imperatives. Many organisations continue to improve their internal stress testing and funding models and to undertake a more comprehensive assessment of the profitability, solvency and liquidity impact of combined enterprise-wide scenarios. As well as regular challenge around ALM/ Treasury and Liquidity Risk Management systems, processes and controls, internal audit can play an important role in providing the independent challenge required by the regulations around banks' readiness to adopt the Basel III liquidity rules in APS 210. APRA recognises that in order for Authorised Deposit-taking Institutions (ADIs) to meet the new LCR (Liquidity Coverage Ratio) requirement, they will need access to a CLF (committed liquidity facility) from the RBA. This is because there are insufficient HQLA (high quality liquid assets) e.g. Australian government bonds available in the market. ADIs are required to take "all reasonable steps" to meet the LCR requirement through their own balance sheet management, before relying on the CLF.

Banks are also in the process of issuing capital instruments that comply with the new capital rules including loss absorption features such as mandatory conversion to equity and write-down provisions. In addition banks are now subject to a credit risk capital charge for credit valuation adjustments (CVA).

Internal audit can play a key role as firms revisit the effectiveness of control frameworks in place to ensure completeness, accuracy and integrity of source data inputs and calculated Risk Weighted Assets (RWA) outputs. The debate around the comparability and consistency of capital models continues, as both regulators and investors seek to better understand the reasons for variances in model results for similar asset portfolios. Against this backdrop of a series of initiatives aimed at enhancing transparency and disclosure within Pillar 3 and annual financial statements, internal audit is set to play a key role in confirming the integrity of the RWA calculations is enhanced.

In summary, Internal audit has an important role to play to assessment the ADIs' progress in implementing Basel III as well as ensuring that the ADIs' implementation of the new rules would satisfy the regulator.

5. Trading

The impact of the rate setting LIBOR scandal is still being felt by financial institutions and regulators worldwide. The spotlight is starting to shine on the processes and controls supporting other indices, benchmarks, and wider price setting processes to which banks contribute. Internal audit is required to conduct a periodic assessment of the governance and organisational arrangements on benchmarks as focus has turned on reviewing benchmark submission processes.

A significant unauthorised trading event could have a potentially terminal impact on many institutions. There is increased focus on developing and enhancing preventative controls and in particular, reinforcing the responsibility of the front office in establishing an appropriate culture and implementing an effective supervisory framework. Reviewing and challenging the effectiveness and completeness of unauthorised trading programs is a focus area for many internal audit functions.

There should exist clear accountability to ensure supervisors are equipped with the appropriate resources and analytic tools to perform their role effectively. Operational risk typically take a lead role in managing unauthorised trading risk, though designing and implementing control frameworks which effectively capture all risks across institutions can prove challenging.

Recent errors and failures in high frequency trading businesses have led to concerns around inadequate trade execution controls which can expose firms (and individuals) to significant losses and significant clampdown from regulators. The challenge to keep on top of these activities is ongoing, due to the dynamic nature of these activities and continued innovation in trading programs. It is critical for firms, with the active involvement of operational risk and internal audit, to constantly assess the control environment to confirm the governance and controls structures are adequately mitigating the risks posed by high frequency trading.

ADIs should be vigilant in this area as there is the high risk of loss and reputational damage due to an unauthorised trading. APRA expects that banks will design and implement plans to strengthen controls in this area and will have in place appropriate monitoring controls, including the use of trade surveillance tools in order to highlight high risk activities and prevent an operational risk event.

6. IT

There is now an increased awareness of the power of using **data analytics** to support internal audit activities which has led to increased demand for enhanced analytics capability. While it is relatively simple to implement analytics tools, developing the skillsets to use such tools effectively, embedding their use into the audit plan and managing the target data is more challenging. Organisations are investing in this capability to help generate more sophisticated insights through audit work. For example, using data analytics to develop more complex hypotheses, joining related data sets which provide new perspectives on control effectiveness or more simply by enabling testing of larger samples.

Payment service providers have been under increased regulatory scrutiny in respect of both resilience and conduct as APRA has been focusing on the new payment service providers which have been outside the regulatory radar of APRA.

The New Payments Platform (NPP), commissioned by the Reserve Bank of Australia, is a new infrastructure for Australia's low-value payments. Expected to be implemented by late 2015, it will provide Australian businesses and consumers with a fast, versatile, data-rich payments system for making their everyday payments. The basic infrastructure will support various 'overlay' services - specially tailored services which individual financial institutions may choose to offer their customers. This multi-layered infrastructure has been designed to promote competition and drive innovation in payment services. The NPP will create new risks and areas of focus including:

- Identifying, selecting, validating and vetting emerging overlay services
- Managing the impact of person to person payments (first overlay/convenience service)
- Managing continued regulatory involvement/ intervention in payments with the evolution of NPP.

Whilst NPP is expected to provide a superior payments experience to consumers and merchants, the platform risks disruption to financial services business models connected to payments. ADIs, card schemes and firms involved with transaction processing and settlement will have to prepare for the competition, liquidity and capacity pressure that will accompany NPP. Other focus areas which internal audit could assist organisations in assessing impact include: the impact of payments on resolution and recovery plans, ring-fencing, intraday liquidity management, FATCA compliance, sanctions compliance and fraud prevention.

The digital revolution has changed the way we do business, but it has also created a sophisticated and complex set of security issues. Exposure to **cyber threats** increases as business embraces the digital world. As the threat of cyber attacks grows, regulatory demands increase and customer confidence can dwindle. Internal audit have a role to play in confirming that organisations are geared to withstand attacks rather than simply trying to prevent them. Organisations are seeking to reduce the net impact and the time it takes to recover from an attack. While it may not be possible to be completely cyber-attack-proof, by carefully devising a cyber security defence and response strategy, organisations can build the next best thing: cyber resilience.

Data governance and quality are high priorities for organisations to tackle due to increasing regulatory attention and the business reliance on high quality data. Internal audit will naturally have assessed aspects of data control previously, for example security and access has been a focus of internal audit for many years but as businesses increase their focus on the customer, digital channels and explicit requirements in regulations, the need to assess the overall governance and quality of data is increasingly pertinent.

User Access Management and Governance has become a focus area of the regulators as a result of a number of spectacular global frauds costing financial institutions hundreds of millions of dollars. Internal audit have a role to play in assessing the ability of organisations to prevent and detect toxic combinations and confirm that an appropriate user access recertification process is in place. This should extend to privilege user management as organisations create more visibility and gain more control in this area.

7. Accounting and taxation

The current tax landscape is more complex than ever with greater media and political debate in relation to 'responsible tax' and tax transparency. There has been widespread public criticism of perceived avoidance of taxes by some financial services organisations globally. In Australia the focus on tax will increase further with the introduction of the tax transparency reporting regime (requiring publication of total income and income tax payable). The increased profile of tax and potential reputational ramifications mean that tax risk management has become a key area of focus for internal audit functions.

Financial services organisations are seeking to ensure their approach to **tax risk management** is aligned with their broader commercial strategy and risk management approach. Internal audit functions face the challenge of assessing whether an organisation's tax governance structure, processes and controls for managing tax risk are embedded throughout the organisation in all business decisions and operations, as well as evaluating if compliance obligations are met across the range of taxes and tax reporting regimes that apply to financial services businesses. Tax risk and governance has also been an area of focus for the ATO in recent years. In December 2012, the ATO published detailed checklists setting out their expectations in relation to strategic and operational tax risk management and governance. Furthermore the ATO now undertakes reviews of tax risk and governance documentation as part of its reviews of company tax returns.

Accounting standard setting bodies have been working on a new **loan impairment** model for some time, addressing the criticisms that the current mixed measurement incurred loss model recognised provisions too little and too late. There remain some practical considerations that internal audit could assist with around firms' transitional plans and assessing availability of data to effectively roll this out. An agreement has been found to shift the principle to an expected loss model but the functioning of the precise model is somewhat trickier and this is not allayed by the growing uncertainty about the final outcome of the financial instruments accounting standard.

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