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The role of internal audit in
recovery and resolution planning

Deloitte Recovery and
Resolution Planning Center
of Excellence

Executive summary

Regulatory rewind

US regulators continue to flex their muscles and push resolution planning as a key regulatory driver to reduce systemic risk and the likelihood of an institution being “too big to fail.” On April 13, 2016, the Federal Reserve Board (FRB) and the Federal Deposit Insurance Corporation (FDIC) (collectively, the “Agencies”) jointly determined, for the first time, that certain resolution plans submitted by domestic systemically important banks (D-SIBs) were “not credible or would not facilitate an orderly resolution”¹ under the US Bankruptcy Code. Further, the Agencies issued prescriptive guidance increasing expectations for the eight US D-SIBs’ resolution plan submissions due July 1, 2017 (2017 Guidance).²

Separately, while there have been several regulatory developments targeted at the eight US D-SIBs, the Agencies have certainly not lost sight of other systemically important financial institutions (SIFIs). On June 8, 2016, the Agencies issued a joint press release extending the deadline for certain foreign banking organizations’ (FBOs) resolution plan submissions from July 1, 2016, to July 1, 2017.³ Further, on August 2, 2016, the Agencies issued another joint press release extending the deadline for the top tier of December filers from December 31, 2016, to December 31, 2017.⁴ The Agencies also advised in both press releases that they will provide firm-specific feedback for each

institution’s 2015 resolution plan as well as guidance for their 2017 submission. These extensions will heighten expectations for each institution’s 2017 submission.

In addition to the resolution planning regulatory developments above, the FRB issued Supervisory Letter (SR 14-8) on September 25, 2014, for consolidated recovery planning of certain large domestic bank holding companies that may pose elevated risk to US financial stability.⁵ The key objective of this supervisory letter is to enhance the resiliency of a firm to adverse developments which, in turn, should lower the probability of its failure or inability to serve as a financial intermediary. Further, the Office of the Comptroller of the Currency (OCC) issued a bulletin on December 17, 2015, to request comment on a proposed rule to establish guidelines for recovery planning for institutions with average total assets of \$50 billion or more (covered banks).⁶ Recovery planning guidelines need to be considered in conjunction with resolution planning requirements.

Internal audit in the spotlight

Over the past several years, banks have faced heightened regulatory scrutiny around capital planning programs, and, subsequently, internal audit’s role in assessing these programs for soundness and compliance with internal and regulatory requirements has increased. In January of 2016, the FRB published a final rule requiring



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chief financial officers (CFOs) of the largest systemic firms⁷ to attest to the “material correctness of data” and to “agree to report material weaknesses and any material errors in the data” submitted in the FR Y-14 forms.⁸ With the implementation of the attestation, internal expectations of internal audit are heightened as stakeholders will be looking to the third line of defense to ensure that effective controls are in place to assure the accuracy of the submission. Most recently, in June 2016, the FRB published its report on the Comprehensive Capital Analysis and Review (CCAR) exercise for larger bank holding companies (BHCs). The FRB noted that “a number of the largest BHCs have weaknesses in their internal audit programs for capital planning, which may limit their effectiveness in assessing the quality of key components of their capital planning practices.”⁹ Additionally, the FRB went on to advise that they would be conducting a “thorough review of the largest firms’ internal audit coverage” as part of the year-round supervisory program supporting CCAR. Because resolution planning has recently received similar focus as capital planning on the regulatory reform agenda, similar regulatory scrutiny is expected on the horizon for internal audit’s role in recovery and resolution planning as the Agencies rely on internal audit to assure that related processes and controls are in place and operational.

Risk powers performance: Internal audit makes its impact

In response to these developments, institutions have allocated more resources and implemented strategic initiatives to address requirements outlined in the recovery and resolution planning guidance. Regulators expect that institutions will embed resolvability concerns into business-as-usual (BAU) processes, potentially modifying risk management practices, contingency planning, operational policies and procedures, and governance practices. The risks arising from the collective action of these moving parts create several opportunities for internal audit as the third line of defense. Internal audit departments

that are able to effectively assess the associated risks can make an impact on business performance and extend their influence among stakeholders.

Currently, the level of internal audit involvement in recovery and resolution planning varies broadly from institution to institution. While some institutions have developed more mature programs with an emphasis on auditing recovery and resolution planning prior to submitting their plans, others are still defining their lines of defense. Institutions are operating under tight cost constraints and the Agencies are sensitive to ensuring that all three lines of defense are allocating adequate resources to address all regulatory mandates. The Agencies have not yet provided specific guidance or commentary on the role of internal audit in assessing the recovery and resolution plans, but the role is evolving similar to what was expected for other regulatory mandates, such as capital planning and stress testing as evaluated during the FRB’s CCAR exercise for larger BHCs. Those expectations are comparable to the aspects of recovery and resolution planning in terms of complexity, broad scope, and an end-to-end evaluation of the integrity and appropriateness of the effort.

In an effort to successfully navigate this complex and dynamic regulatory landscape—and power improved performance—internal audit should:

- Develop an appropriate framework and strategy for the evaluation of recovery and resolution plans, taking into consideration the interrelationship between recovery and resolution plans and other regulatory requirements involving the first and second lines of defense as well as competing priorities
- Identify audit objectives based on the seven key vulnerabilities identified by the Agencies’ 2017 Guidance²
- Evaluate the current audit plan and map objectives for each key vulnerability area to planned audits to identify gaps in coverage

- Perform a risk assessment to drive the type, scope, and intensity of the audits
- Identify skill sets and training required to execute the enhanced audit plan for recovery and resolution planning
- Communicate key findings, limitations, status, and results for recovery and resolution planning to appropriate stakeholders
- Establish a continuous monitoring program to oversee risk management, control, and governance processes

Internal auditors looking for a roadmap to evaluate their firms’ recovery and resolution plans can reference a few existing resources. First is the 2017 resolution planning guidance itself, which clearly describes the new and enhanced requirements and expectations for resolution plans. Second are the firm-specific feedback letters which provide insight into the Agencies’ rationales for individual firm resolution plan determinations. And third, the Agencies’ disclosures referencing the high-level components of the assessment framework used to evaluate and issue joint determinations on the 2015 resolution plans.¹⁰ In addition, they should consider the requirements from the FRB and OCC for recovery planning.

Ultimately, internal audit should evaluate whether the planning process had adequate governance and controls and produced a plan or related recovery and resolution capability that is complete, accurate, and consistent with internal and regulatory expectations. Taking it further, leading internal audit departments should find opportunities to turn the complex business issues associated with recovery and resolution planning into an opportunity for growth and resilience.

Internal audit framework for recovery and resolution planning



The 2017 resolution planning guidance outlines requirements and expectations for seven “key vulnerabilities” that apply across resolution plans and should be addressed in the 2017 submission. The below framework outlined for resolution planning will also apply for the institutions required to submit a recovery plan as components of the framework are key elements of both recovery and resolution planning:

- Capital
- Liquidity
- Governance mechanisms
 - Payment, clearing, and settlement activities
 - Managing, identifying, and valuing collateral
 - Management information systems
 - Shared and outsourced services
 - Legal obstacles associated with emergency motions
- Legal entity rationalization and separability
- Derivatives and trading activities
- Public section

Still, while this structure may be viewed as simple and straightforward, internal audit should remain cognizant of the interdependencies that exist between each of the key vulnerability areas; they shouldn't be viewed in silos. They also should be viewed in relation to other regulatory mandates and business processes. Even when each of these areas is determined to be effective individually, internal audit should also assess whether they come together collectively to form a sound recovery and resolution plan.

These seven areas provide insight into the assessment framework that the Agencies will use to evaluate and issue determinations on the 2017 resolution plans. Accordingly, it may benefit internal audit to leverage a similar framework, aligning their end-to-end internal audit program with these key vulnerabilities identified by the Agencies.



Figure 1

Figure 1 represents a framework outlined for resolution planning and will also apply to institutions required to submit. Over the past several years, banks have faced heightened regulatory scrutiny around capital planning programs, and, subsequently, internal audit's role in assessing these programs for soundness and compliance with internal and regulatory requirements has increased.

Internal audit strategy for recovery and resolution planning

Internal audit functions have broad visibility and a mandate that cuts across the entire organization, enabling them to provide insights and perspectives which can aid management as they address significant regulatory requirements. Considering the pervasive effects recovery and resolution planning has on financial institutions, internal audit has never had a better opportunity to demonstrate its true value. Internal audit should consider the expectations of its stakeholders and develop an appropriate internal audit strategy for recovery and resolution planning. Each stakeholder will have different expectations. The audit committee and other board members will naturally look to internal audit to advise based on

the assertions made by management. Management will also look to internal audit for advice and objective assurance on the recovery and resolution planning actions implemented. Internal audit will be an effective sounding board by challenging management's approach to decisions, processes, and remediation activities. Further, similar to other areas, internal audit can expect regulators to review their ability to assess an institution's adherence to these requirements. As a result, an effective internal audit strategy plays a crucial role in the regulatory assessment of recovery and resolution planning.

As noted previously, many firms have launched transformative projects to comply with the newly published regulatory guidance and internal audit is an integral component of these projects. Specifically, internal audit departments are expected to be strategic assets for the Agencies in helping to enforce and assess planning related to recovery and resolution requirements. To fulfill this expectation, internal audit should approach coverage of recovery and resolution planning from an enterprise-wide, end-to-end perspective and consider the dependencies and interconnections of each element of recovery and resolution planning, rather than solely relying on testing of individual controls.

Figure 2 depicts the components of an internal audit strategy, which should encompass for internal audit to position itself as a trusted advisor to the audit committee, other board members, and management, while meeting the expanding expectations of regulators for recovery and resolution planning



Figure 2

Internal audit objectives

In developing an end-to-end strategy, internal audit should first identify audit objectives based on the seven key vulnerabilities cited by the Agencies. Objectives should include assessing the effectiveness of individual components of recovery and resolution planning, as well as the convergence of the elements to generate sound recovery and resolution plans. It is essential to note that building objectives based on the key vulnerabilities is a reactive strategy to coverage; therefore, internal audit should also work to identify additional objectives to stay ahead of regulatory scrutiny in the coming years. Internal audit should consider guidance on other transformative projects such as CCAR, specifically Supervision and Regulation Letter 15-18—“Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISC Firms and Large and Complex Firms”¹¹ to identify additional objectives.

Coverage mapping

Internal audit must have an understanding of the current coverage plan and the maturity of recovery and resolution planning activities to identify weaknesses and enhance processes to meet regulatory guidance. Once internal audit objectives have been identified, internal audit should then evaluate the current audit plan and map objectives for each key vulnerability area to planned audits. Based on this assessment, internal audit should then identify regulatory requirements with little to no audit coverage. In conducting this assessment, internal audit should not only consider specific guidance related to recovery and resolution planning, but should also consider regulatory guidance directed toward the role of the third line of defense, specifically Supervision and Regulation Letter 13-1—“Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing,”¹² which directs internal audit departments to incorporate enhanced practices related to risk analysis, thematic control issues, challenging management and policy, infrastructure, risk tolerance, and governance and strategic objectives into existing overall processes.

Following the completion of the objectives mapping, internal audit should develop action plans to address identified coverage gaps and potential enhancements to the current audit plan components satisfying recovery and resolution planning requirements. In order to develop a comprehensive action plan for adequate coverage, internal audit should conduct proactive discussions with the subject matter experts, audit committee, other board members, and management to understand expectations, concerns, and priorities.

Risk assessment

Once internal audit completes the essential steps of identifying audit objectives and addressing coverage gaps, they should perform a risk assessment. The risk assessment drives the type, scope, and intensity of audits for the seven key vulnerabilities identified by the Agencies. Internal audit should revisit its risk assessment framework to determine the adequacy of risk coverage for recovery and resolution planning and whether enhancements are needed. The risk factors to consider when developing a risk assessment for recovery and resolution planning should include, but not be limited to, the following:

- The degree to which the components, processes, or infrastructure of the recovery plan and the resolution plan are
 - new or has not been reviewed
 - interdependent with other essential areas and key vulnerabilities
 - complex or difficult to implement or execute
 - wide in scope or impact
- Other internal or third-party risk assessments
- The degree, speed, and importance of change management underway
- Prior audit or regulatory findings
- Current status of key projects underway

Based on the assessment of risk factors outlined above, internal audit should prioritize the areas that require the greatest degree of scrutiny and testing to ensure a thorough understanding of the quality of the recovery and resolution plans or capability area.

Resource planning

The execution of a successful internal audit strategy for recovery and resolution planning will be significantly dependent on adequate resource planning. Based on the coverage plan and risk assessment, internal audit should perform a skill-set assessment and gap analysis to identify the skills and training required to execute the enhanced audit plan for recovery and resolution planning. Internal audit should develop a program to alert internal audit members, on a timely basis, of recovery and resolution planning-related activities within the organization and the latest regulatory developments. This may include additional training, where necessary, to improve internal audit’s ability to provide value-added audit coverage and enhanced communications that provide timely information for company issues and allow for changes in the institution’s strategies and remediation activities. Since institutions operate in an environment of tight cost controls, a plan to implement over time may need to be developed to identify where gaps may continue to exist and when they will be addressed.

Internal audit reporting and issue management

Communication of key findings, limitations, risks, status, and results for recovery and resolution planning and related capabilities to the appropriate stakeholders is a critical component of internal audit’s strategy. Internal audit should provide periodic updates to the audit committee, other board members, and senior management regarding internal controls, progress against the audit plan, identified limitations, significant findings, and internal audit’s assessment of related remediation activities. Where the recovery and resolution planning process is still in the development phase and there are separate recovery and resolution planning steering committees, internal audit should be reporting to them, especially with regard to audits covering remediation activities.

To provide accurate reporting, internal audit should develop an effective issue management and tracking system. As recovery and resolution planning activities are pervasive throughout the organization, internal audit should ensure that the issue management and tracking system is capable of representing not only its own findings and remediation status for recovery and resolution planning areas, but also findings and remediation status associated with all relevant sources such as regulatory examinations, risk management reviews, and management self-assessments.

The final step for an effective internal audit strategy for recovery and resolution planning is the preparation of an audit report that provides a consolidated view of regulatory compliance with recovery and resolution planning requirements. The audit report should aggregate recovery and resolution planning-related audit activities into a consolidated opinion that looks into the institution's recovery and resolution planning process holistically and connects conclusions across various work streams in an end-to-end fashion. The significant sections that could be incorporated into the audit report include, but are not limited to:

- Details on audit procedures performed
- Outstanding internal audit findings and management action plans

- Mapping of the internal audit results to seven key vulnerability areas
- Common themes and challenges noted in the recovery and resolution planning audit activities

Clear documentation of internal audit's work on recovery and resolution planning and a thorough reporting process should improve the likelihood of reliance by regulators.

Continuous monitoring

Internal audit should be proactive to ensure their work can be relied upon internally and by regulators, especially as conditions, practices, or expectations shift. To achieve this, internal audit should establish a comprehensive continuous monitoring program to oversee the risk management, control, and governance processes for recovery and resolution planning. The continuous monitoring program should ensure ongoing internal audit activities that will assist in identifying changes in the institution's risk profile and position internal audit to provide appropriate risk and control consultation across the organization. This ongoing engagement should support internal audit's assessment of recovery and resolution planning activities, as well as risks that should be considered as part of the audit plan.

The continuous monitoring program should enable internal audit to stay abreast of emerging changes, issues, and risks that should be incorporated into the coverage plan, risk assessment, and audit plan for recovery and resolution planning on an ongoing basis.

Documentation of internal audit strategy

Internal audit should document the end-to-end strategy for recovery and resolution planning coverage. This document should act as a comprehensive roadmap for how the identified audit objectives will be met and should clearly articulate to regulators how internal audit will assess recovery and resolution planning from a holistic and integrated perspective. The document should be actionable and demonstrate how end-to-end coverage will be achieved—not just that it will be achieved. The internal audit strategy document should be dynamic and adjusted on a regular basis as recovery and resolution planning activities mature, new developments are identified through continuous monitoring, and risk changes are recognized via the ongoing risk assessment procedures.

The internal audit strategy document should be dynamic and adjusted on a regular basis as recovery and resolution planning activities mature, new developments are identified through continuous monitoring, institutions' business and structure evolve, and risk changes are recognized via the ongoing risk assessment procedures.

Considerations going forward

- **Internal audit to play a larger role:** The Agencies now place greater reliance on internal audit as their regulatory mandate has significantly expanded. There needs to be strong governance across the plan and internal audit should ensure consistency, integrity, and cohesiveness across the plans. Further, internal audit should play an integral role in the governance structure of the institution, assessing the institution’s plans and processes before they meet regulatory scrutiny.
- **Institutions need to remain responsive to feedback and guidance:** One of the seven key areas focuses on how an institution complies with prior feedback and takes feedback into account in

developing future resolution plans. Once expectations are set, failure to comply and remain non-responsive may result in ruling that a plan is not credible. Internal audit must play a proactive role in identifying enhancements and staying ahead of regulatory expectations.

- **Progress has not stopped since the 2015 plan:** While improvements may have been made following the submission of 2015 resolution plans, institutions will need to re-evaluate improvements in light of the 2017 guidance and any identified deficiencies and shortcomings.
- **Regulatory guidance and expectations should not be viewed in silos:** Institutions will need

to think strategically and efficiently to allocate resources and define capabilities as regulatory costs and expectations continue to rise. A more cohesive plan can also be developed when considering all aspects as an integrated whole. Success can be judged by an institution’s ability to self-identify issues, and internal audit is an integral part of that process.

- **Risk powers performance:** Proactive insights from internal audit can have a profound impact on the outcomes of recovery and resolution planning, positioning institutions to exceed stakeholder expectations while driving growth and resilience.

In light of expanding expectations and increasing regulatory scrutiny for recovery and resolution planning:

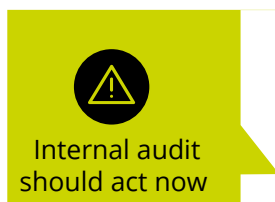


Figure 3

Endnotes

¹ Agencies Announce Determinations and Provide Feedback on Resolution Plans of Eight Systemically Important, Domestic Banking Institutions

<http://www.federalreserve.gov/newsevents/press/bcreg/20160413a.htm>

² Guidance for 2017 §165(d) Annual Resolution Plan Submissions By Domestic Covered Companies that Submitted Resolution Plans in July 2015,

Federal Deposit Insurance Corporation and Board of Governors of the Federal Reserve System (April 13, 2016), available at

<https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160413a1.pdf>

³ Agencies Extend Deadline for Certain Foreign Banking Organizations' Resolution Plan Submissions (June 8, 2016), available at

<https://www.federalreserve.gov/newsevents/press/bcreg/20160608a.htm>

⁴ Agencies Extend Deadline for 38 Resolution Plan Submissions (August 2, 2016), available at

<http://www.federalreserve.gov/newsevents/press/bcreg/20160802a.htm>

⁵ SR Letter 14-8, "Consolidated Recovery Planning for Certain Large Domestic Bank Holding Companies" (September 25, 2014), available at

<https://www.federalreserve.gov/bankinfo/srletters/sr1408.htm>

⁶ OCC Bulletin 2015-50, "Enforceable Guidelines for Recovery Planning" (December 17, 2015), available at <http://www.occ.treas.gov/newsissuances/bulletins/2015/bulletin-2015-50.html>

⁷ Listing of LISCC Firms available at <http://www.federalreserve.gov/bankinfo/large-institution-supervision.htm>

⁸ 81 Fed. Reg. 3,412 (Jan. 21, 2016), available at <https://www.federalreserve.gov/boarddocs/press/foiadocs/2016/20160121/foia20160121f.pdf>

⁹ Comprehensive Capital Analysis and Review 2016: Assessment Framework and Results, Board of Governors of the Federal Reserve System

(June 2016), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160629a1.pdf>

¹⁰ Resolution Plan Assessment Framework and Firm Determinations (2016), Board of Governors of the Federal Reserve System and Federal

Deposit Insurance Corporation, available at <https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160413a2.pdf>

¹¹ SR Letter 15-18, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms"

(December 18, 2015), available at <http://www.federalreserve.gov/bankinfo/srletters/sr1518.htm>

¹² SR Letter 13-1, "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing" (January 23, 2013), available at

<http://www.federalreserve.gov/bankinfo/srletters/sr1301.htm>

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