INTERNAL AUDIT SUPPORT

BANKING & BUILDING SOCIETIES

March 2023

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BDO FS INTERNAL AUDIT CONTACT POINTS

BDO's Banking & Building Societies Update summarises the key regulatory developments and emerging business risks relevant for all banks, building societies and, where flagged, for alternative finance providers (i.e. peer-to-peer lenders, card providers, E-money services providers and debt management companies).

Our FS Advisory Services team are working with more than 50 banks and building societies as internal auditors and advisors, giving us a broad perspective on the issues facing the sector. We have aggregated insights from our in-house research, client base, the Regulators and professional bodies, including the Chartered Institute of Internal Auditors (CIIA), to support your audit plans and activities.

We hope this pack provides value to you and your colleagues; please do share with us any feedback you may have for our future editions.

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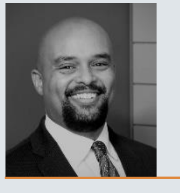

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2023 REGULATORY PRIORITIES

2023 REGULATORY PRIORITIES

PRA 'dear CEO' letter for Deposit-takers

REGULATOR	SECTOR RISK	PRA FOCUS
Credit Risk	The impact of increasing interest rates, inflation and high cost of living, geo-political uncertainty, and supply chain disruptions is expected to pose challenges to firms' credit portfolios. In recent years, firms have tightened underwriting standards, enhanced forbearance tools, and increased operational preparedness for collections. However, these enhancements are untested under the current combination of risk factors.	Focus will centre on higher risk areas including retail credit card portfolios, unsecured personal loans, leveraged lending, commercial real estate, buy-to-let, and lending to SMEs. The PRA will review firms' early warning indicator frameworks and make requests for enhanced data and analysis.
Financial Resilience	The PRA expects firms to take proactive steps to assess the implications of the evolving economic outlook on the sustainability of their business models. This should include consideration of broader structural changes, such as the evolution of new financial technology and competition.	The PRA will continue ongoing assessment of individual firm's capital and liquidity positions as well as how these may evolve in light of potential headwinds. Areas of focus will include the impact of evolving retail and wholesale funding conditions, as well as scheduled maturities of drawings from the Term Funding Scheme in the coming years. Supervisors will continue to work with firms as they seek to enhance their own testing and scenario development capabilities in response to the current environment.
Risk Management & Governance	The default of Archegos Capital Management and recent market volatility from the Russia/Ukraine conflict have shown that firms continue to unintentionally accrue large and concentrated exposures to single counterparties, without fully understanding the risks that could arise.	PRA will continue to assess firms' risk management and control frameworks through individual and cross-firm thematic reviews. Regulatory supervisors will focus on firms' ability to monitor and manage counterparty exposures, particularly to non-bank financial institutions. Given the global nature of market events, the PRA will continue to work closely with its global regulatory counterparts on these topics.
Operational Risk & Resilience	In response to increasing digitisation, changes in payment systems and the need to address legacy IT systems, many firms are executing large and complex programmes of IT change. There has been a material increase in services being outsourced, particularly to cloud providers, and the number of firms offering crypto products continues to grow, presenting new challenges for risk management.	The PRA will continue assessment of firms against the operational resilience requirements, firms' own self-assessments, and the testing that firms are conducting. The PRA also expects large-scale IT changes to be well managed with the associated transition and execution risks appropriately mitigated, outsourcing arrangements to meet the expectations on outsourcing and third party risk management. Focus will include firms' use of new technologies, and advancements in asset tokenisation as firms are expected to have fully understood the impact of offering crypto products on their operational resilience.

2023 REGULATORY PRIORITIES

PRA 'dear CEO' letter for Deposit-takers

REGULATOR	SECTOR RISK	PRA FOCUS
Model Risk	The weaknesses that the PRA highlighted in its 2022 priorities letter for Model Risk Management remain a priority.	The PRA expects to publish finalised MRM principles for banks in H1 2023. For Internal Ratings Based models, the regulator will continue to focus on three key workstreams: the implementation of IRB Hybrid mortgage models; the IRB Roadmap for non-mortgage portfolios; and IRB aspirant firm model applications. Focus will include new Fundamental Review of Trading Book (FRTB) models and firms' intended methodologies.
Regulatory Reporting	Repeatedly identified deficiencies in the controls over data, governance, systems, and production controls related to regulatory reporting.	The PRA expects firms to consider the thematic findings set out in its communications on regulatory reporting to help improve future submission and the regulator will continue to use skilled persons reviews in this area in 2023.
Climate Change	The level of embeddedness of PRA climate change financial risk requirements (PRA SS3/19) varies across firms.	The PRA expects firms to take a proactive and proportionate approach to addressing risks in this area as set out in its most recent Dear CEO letter.
Diversity, Equity & Inclusion	A new consultation paper expected this year setting out proposals to introduce a new regulatory framework on DEI in the financial sector.	
Resolution	Firms need to continue to ensure that they achieve, and can continue to maintain, the resolvability outcomes of the Resolvability Assessment Framework, and ensure that they are transparent in their disclosures about their preparations for resolution.	

02

MEET THE TEAM

RICHARD WEIGHELL
Partner, Financial Services Advisory

MEET THE TEAM

Each month, we shed more light on our FS Internal Audit practitioners so that we can get to know the person behind the practice in 10 questions. This month, we get properly introduced to Richard Weighell.

1. What has been your career leading into BDO?

I started out in industry as a management accountant, but after a year I got the chance to try out internal audit and loved it. I moved into professional practice and did a fair stint in external audit before getting the chance to move back into internal audit with a mix of risk consulting projects and worked my way up to senior manager. Then in 1999, I took what felt like a bold step in taking a role in Pannell Kerr Forster as a director with a remit of setting up an internal audit function. After a few anxious months of wondering if that was a bad decision, the momentum started to build, with a team established and the work started coming in covering lots of sectors. That got me partnership in 2001. The business grew and then the rebranded PKF merged with BDO in 2013 and I went with it. After a couple of years at BDO I specialised fully in financial services. And here I am.

2. Describe your role in the FS Internal Audit team?

There are broadly four strands to what I do. First and foremost, I am the lead on a mix of outsourced and co-sourced internal audit engagements, mainly working with the banking and capital markets/platforms sectors. I don't generally do reviews, but I am active in understanding the businesses, determining what we review, making sure what we do is of the right quality and in context, and communicating the results.

Second, I lead our FS climate and ESG reviews, which are a mix of internal audits, assurance reviews and advisory engagements. Then I am responsible for quality and risk across FS Advisory, so practicing what I preach for our own business. And finally, there is the role of leading the team. Fortunately, we have a lot of talented people. My role is to get the best out of them.

3. What's the most interesting thing you're working on right now?

I love helping clients sort out problems, so probably the two projects that have got my attention most at the moment is one about working out how something went horribly wrong and how to put in right, and the other is helping a firm to work through the embedding of ESG in their business.

4. Best thing about being part of the Internal Audit Team?

I love working with people. The Internal Audit team has people from different backgrounds and skills and we handle a wide variety of clients and projects and hopefully stay with our clients for a number of years and really get to know them. The Internal Audit team is a pretty social group and we enjoy ourselves.

5. What drives you to do what you do?

I like working with people. I love helping sort out issues and coming up with ideas. When the day finally comes that I hang up my pen, I will need to find something to replace that buzz.

6. What's something that has surprised you about your IA career path?

That it opens you up to such a mix of people and businesses, of all kinds, that it really could have gone into any number of specialisms, locations or size of function. If you told me in my 20's as a humble accountant what I would be doing now on a day-to-day basis, I doubt I would have believed you!

7. What's the best piece of professional advice you've ever received?

Follow your instincts but back your views up with evidence.

8. How do you see internal audit changing over the next few years?

More use of data to provide in depth reviews and ongoing monitoring. More focus on what traditionally were seen as softer areas such as culture, conduct and competence. A greater diversity of skills in the teams.

9. What is your favourite thing to do when you're not working?

Too many things to choose from. I am a big rugby and cricket fan and an obsessive runner. I love my food and wine. I cultivate bonsai trees. I love going to new places. My life has a musical soundtrack.

10. If you were stranded on a desert island, what three items would you want to have with you?

My Swiss army knife, something that played music with a battery that never runs down and a close friend.

03

FCA DISCUSSION PAPER ON SUSTAINABILITY CHANGE – WILL VOLUNTARY DISCLOSURES SOON BECOME REGULATORY REQUIREMENTS?

GLORIA PEREZ TORRES
Senior Manager

FCA DISCUSSION PAPER ON SUSTAINABILITY CHANGE

Will voluntary disclosures soon become regulatory requirements?

BACKGROUND

On 10 February 2023, the FCA published Discussion Paper DP23/1: 'Finance for positive sustainable change' which seeks stakeholder views on whether more regulation would be beneficial for firms to embed sustainability matters in areas such as governance, remuneration, incentives, strategy and accreditation for sustainability professionals.

At this stage, the discussion paper does not make any concrete regulatory proposals; however, it does pose 15 questions for stakeholder debate, mainly on whether there is a need to regulate the aforementioned areas. Below, we consider what DP23/1 could mean for firms in the financial services sector and, more specifically, for internal auditors when reviewing sustainability control frameworks.

EXPECT INCREASED SUSTAINABILITY REGULATION IN THE NEAR FUTURE

In the UK, the regulatory focus on ensuring that the financial sector supports an economy-wide transition to net zero, and a more sustainable future, is widely known and we have indicated in previous monthly editions of this pack that we expect increased regulation and supervision. The potential move beyond disclosure-based initiatives, as expressed by the FCA in DP 23/1, should, therefore, not come as a surprise to firms.

What is important to note is the aim of the DP, which was clearly stated by the FCA as gathering views on how to 'move effectively from disclosure-based initiatives' to regulation, encouraging firms as they develop sustainability arrangements in areas such as:

- Stewardship, governance, resourcing, and associated incentive mechanisms
- Conflict of interest policies (mainly for FCA-regulated asset managers and asset owners)
- Board skills and awareness of sustainability matters, diversity and inclusion for decision making and delivering effectively on sustainability commitments
- Senior management responsibilities for sustainability-related strategy and the delivery of the firm's climate transition plan
- Governance and oversight of products with sustainability characteristics, or that make sustainability-related claims. For example, to clarify the roles and expectations of governing bodies such as Fund Boards
- Remuneration incentives and alignment to sustainability related strategic priorities.

FCA DISCUSSION PAPER ON SUSTAINABILITY CHANGE

Will voluntary disclosures soon become regulatory requirements?

WHAT SHOULD INTERNAL AUDIT TEAMS THINK ABOUT?

Throughout the discussion paper, the FCA references a variety of existing initiatives such as the Task Force on Climate-related Financial Disclosures ('TCFD') Recommendations, the Transition Plan Taskforce ('TPT') Disclosure Framework and Recommendations (draft), the Consumer Duty and the UK Stewardship Code.

This constitutes a useful reminder for internal auditors regarding the FCA expectations over environmental and social objectives, policies, strategies and competence to deliver effectively on sustainability objectives.

Per the FCA, the expectation is that TCFD disclosures should be used by firms to demonstrate that climate issues have received appropriate board and senior management attention.

In terms of culture, the FCA is focused on four key drivers: purpose, leadership, governance, and approach to rewarding and managing people. Culture must be aligned with sustainability-related strategic ambitions through leadership and training programmes, human resources, policies and procedures and wider workforce engagement.

In addition, the FCA clarifies that they expect published sustainability commitments to be supported by a credible strategy to deliver on those commitments. A sustainability strategy, to be credible, needs to include a suitable timeframe and milestones, articulation of the interaction with other parts of the business plan, identification of roles, responsibilities and accountability, and link with incentive structures – potentially including remuneration linked to achieving sustainability objectives. Internal audit plans must, therefore, cover those components in order to ensure framework alignment.

From a training and competence perspective, firms should be prepared to demonstrate the arrangements they have put in place. Sustainability, or a desire to 'make a difference' is not sufficient. Subject matter expertise needs to be developed by credible and proven upskilling approaches. The FCA is keen to avoid 'competence washing' in firms in an effort to improve their ESG performance. Genuine capability-building among firms needs to be built through appropriate training needs assessments and programmes.

The FCA is interested in hearing from firms on how they are embedding a clear ESG purpose, how this relates to sustainability objectives, and the strength of the 'tone from the top' on sustainability-related matters from both an environmental and a social perspective. Comments on the DP can be submitted until 10 May 2023.

04

RISK MANAGEMENT -
INSIGHTS FROM OUR
RECENT INTERNAL AUDITS

SONAL SHAH
Senior Manager

RISK MANAGEMENT

Insights from our recent internal audits

In this ever-changing and evolving economic, political, and regulatory climate, effective risk management must remain at the forefront and uppermost on the senior management's agenda.

The PRA reminds us that 'The board and senior management are responsible for ensuring that an adequate risk management framework is in place, which is tailored to the nature, scale and complexity of the business and its risk profile'.

While the board and senior management are ultimately accountable for ensuring the firm operates within an effective risk management framework, risk management should be every colleague's responsibility to varying degrees.

For Internal Audit, risk management is central to the purpose of the IA function (…"to evaluate and improve the effectiveness of risk management, control, and governance processes) and essential for the correct performance of internal audit assurance and consulting services (Performance Standard 2120 – Risk Management"). Therefore, IA teams should demonstrate leadership in the development and enhancement of the firm's enterprise risk management, more commonly seen in the sector as the firm's risk management framework.

ESTABLISHING AND MAINTAINING A RISK MANAGEMENT FRAMEWORK

During the early stages of a firm's business development, e.g., following FCA and/or PRA authorisation, the identification of key risks and establishment of a risk management framework is usually performed using a top-down approach, which should be led by the Chief Executive and applicable senior management.

The Head of Internal Audit, and wider IA function, can play a substantial supportive role in this process through:

- **Industry benchmarking** - Considering the risk management frameworks in comparable firms within the sector, identifying good practices for common processes, such as risk assessments
- **Workshops/staff training** - Delivering a risk management training programme as a facilitative consulting engagement to the business
- **Horizon scanning** - Coaching the business to develop a wholistic horizon scanning process for the identification of emerging risks (which we covered in greater detail in September 2022 of this monthly pack).

As the firm evolves its business model and matures its risk management processes, the key risks to the firm should, in general, be identified, assessed, mitigated and managed by the use of advanced tools, such as Risk and Control Self-Assessments (RCSAs), that are led by a bottom-up approach, i.e., the business teams taking active ownership of their risks.

RCSAs, like many other assessment tools, are not meant to be a static document or 'one-off' exercise; rather, these assessments should be maintained on a periodic basis, proportionate to the risk profile of the business area, and be led by the business' senior management to ensure that risk management arrangements remain effective. Where issues are identified through RCSA exercises, these need to be documented and escalated appropriately in a timely manner.

To ensure the RCSA is objective and adds value to the firm, the IA function should have a facilitative role in the process and independently report the results to the board and senior management.

RISK MANAGEMENT

Insights from our recent internal audits

CULTIVATING THE RIGHT RISK CULTURE

One of the fundamental pillars to achieve a consistently effective risk management framework is by embedding a supportive risk culture. This is achieved by:

- **Leadership:** The 'tone at the top' needs to emphasise effective risk management as essential for the sustainable success of the business through, for example, town hall messages incorporating high level feedback on the firm's risk profile following significant business changes, current state of regulatory engagement, recent stress test results, etc. to ensure the firm's leadership is actively engaging the staff on risk management developments
- **Staff training:** Ensuring that all employees receive ongoing risk training and various initiatives to raise risk awareness, as well as managing risk issues (e.g., incidents) as learning opportunities to help continuously develop the risk management framework
- **Embracing operational resilience:** The essence of operational resilience is that risks will, most certainly, materialise at some point; but having an effective response to get the business back on its feet should be the aspired attitude, rather than primarily focusing on 'who's to blame?' as soon as an incident occurs. The incident post-mortem, which Internal Audit can (and should) support, will bring out the accountable colleagues and processes as the root cause of the incident.

WHAT SHOULD INTERNAL AUDIT TEAMS THINK ABOUT?

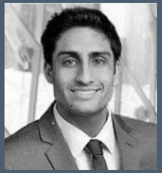
Having noted the above, we do come across a number of common issues from the risk management internal audit reviews we perform for a variety of financial services firms.

Below is a selection of themes to which IA teams should be vigilant:

- **Three Lines of Defence:** The 1LOD and 2LOD blur their respective roles and responsibilities, thereby impacting on the proactive ownership of risks by the business and the effectiveness of the oversight activities undertaken by Risk, Compliance etc. Often this occurs where staff migrate between the lines of defence and carry on their historic roles beyond their transition (i.e., keeping within their comfort zone) or pushback from either the business or oversight teams leading to an imbalance in workload/responsibilities (i.e., egos at play in the boardroom)
- **Inadequate documentation and/or supporting evidence:** Some firms work on the presumption that Senior Management Functions neatly align with the expected roles of a Three Lines of Defence model; however, without clear documentation to evidence the model's existence, and its constituent SMFs and their responsibilities mapped to the firm's Responsibility Map, there is no discernible enterprise risk management taking place for the firm's advisors, or the Regulator, to engage with
- **Lack of defined Risk Taxonomy or inconsistent application of Risk Taxonomy:** Best illustrated by example – The concept of 'Financial Risk' can mean different things to different personnel (e.g., CFO vs. CRO). The use of common terms interchangeably across the firm's risk management framework can give the misleading appearance that risks have been comprehensively identified and managed with an appropriate risk response. It is critical that an approved firm-wide risk taxonomy with clear definitions, and practical examples, is consistently adhered to in the production of formal documents and discussion of the firm's risks
- **Compulsory Business Training (CBT) modules:** Where training tends to be largely or wholly reliant on CBT modules, staff typically have a limited and, largely, theoretical knowledge of the firm's risk management framework at best. This comes across in staff interviews within post-mortem and remediation engagements following a significant incident. A recent example is where staff confuse 'tipping off', within the context of financial crime investigations, with 'inside information' in the context of Market Abuse Regulation (MAR) – the former is a criminal offence, the latter can be managed appropriately as part of a MAR compliance programme.

05

EFFECTIVE
RESOURCE MANAGEMENT



SHRENIK PAREKH
Director

SCOTT THOMPSON
Manager

EFFECTIVE RESOURCE MANAGEMENT

RESOURCING CHALLENGES

Whether your firm has a mature, in-house, internal audit activity or outsources its risk and controls assurance requirements to a third party service provider, the challenge of achieving effective resource management to deliver an agreed upon audit plan will never cease. In this article, we consider the key factors driving the resource management decisions for in-house Heads of Internal Audit, who have a dedicated IA team, and what options they would have in harnessing external expertise.

THE CONSTANT CHALLENGE FACED BY HEADS OF INTERNAL AUDIT

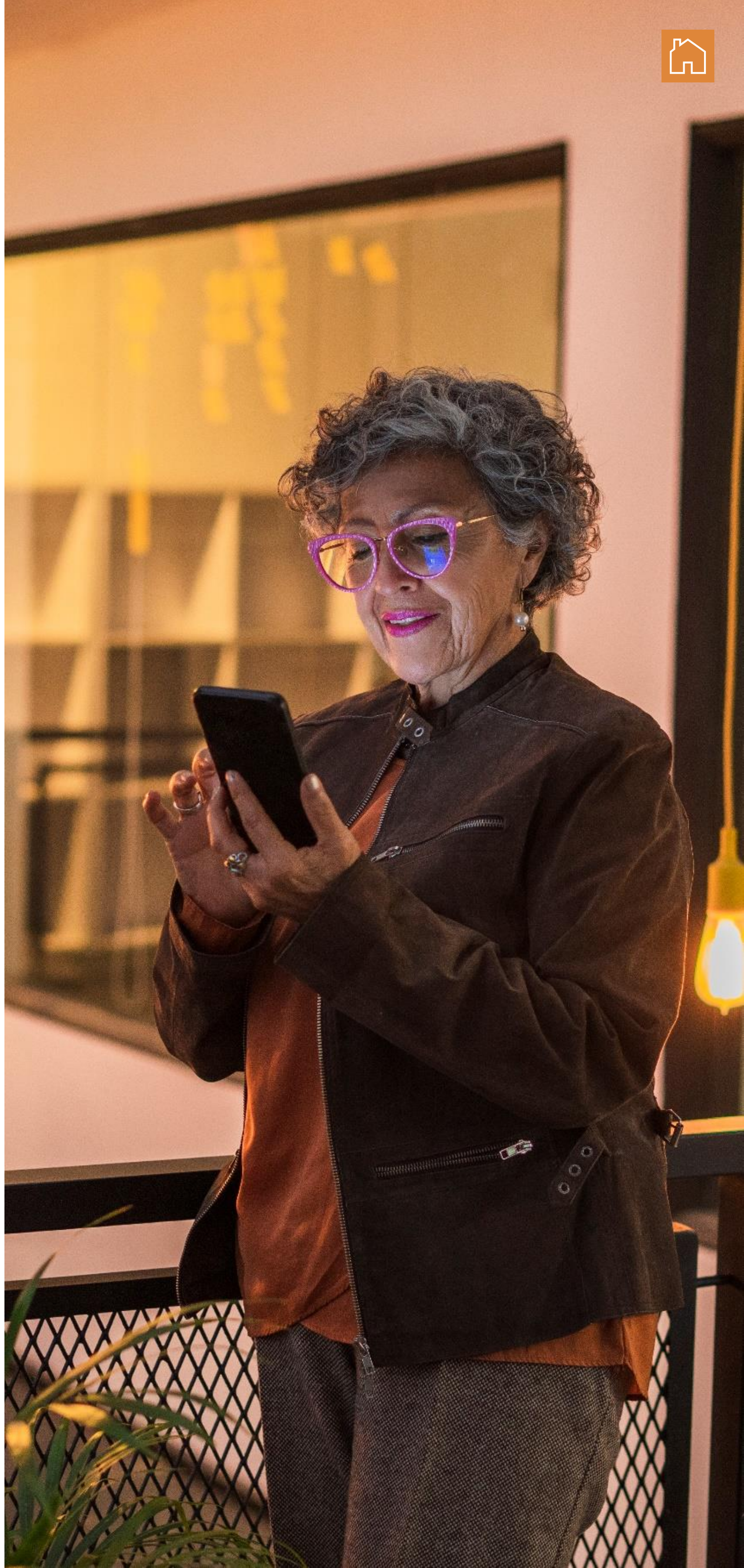
Heads of Internal Audit have to establish a function that ensures both appropriate technical skills, knowledge and competencies, as well as a sufficient amount of resources to deliver the agreed upon audit plan. The IIA standards captures this clearly within PS 2030 ('Resource Management') and, for the financial services sector, codified under Section F of the CIIA's Internal Audit Financial Services Code of Practice ('Resources').

In practice, the role of the Head of Internal Audit is one of prioritising as there will always be a constraint on the resources that a firm is willing to dedicate to it, and sometimes the number of reviews a business can cope with. But it is important that in getting the plan the right size for the resources i.e., a combination of shedding less important audits, certain reviews being deferred into next year or re-incorporated into the assurance activities of 2LOD teams, there could still remain significant limitations to achieve the plan with the current skills available within the team, and in some cases covering for posts that are hard to fill. So what can you do? Same as you would expect for a response to any type of risk, you either:

- **Avoid:** Not really an option here. You'll have to achieve a plan approved by the AC
- **Accept:** Accepting a substantial reduction in the audit plan down to its bare essentials is possible, but likely undesirable in our ever-changing regulatory landscape. The list of 'must-haves' for most regulated firms keeps growing, e.g., AML/KYC, conduct risk, climate change risk, prudential risk, operational resilience, consumer duty etc., and the risk to the firm climbs considerably if audit coverage cannot address the minimum, critical assurance requirements
- **Mitigate:** Mitigating the resourcing risks can take different forms, including:
  - Providing advanced training to staff, whether internally or through an external advisory team
  - Organising a recruitment pipeline, typically with a third-party recruitment specialist to maintain an accessible pool of talent with a sensible lead time
  - Implementing a rotational audit plan, whereby secondees from first and second line teams can bolster the skills base for highly technical reviews. Provided independence and objectivity requirements are safeguarded, rotational audits can also enhance internal audit's reputation within the firm and better demonstrate the value that the function provides the business.

EFFECTIVE RESOURCE MANAGEMENT

- **Escalate:** If after all mitigation efforts are expended, then escalation to the AC Chair would be the next port of call. As the Standards clarify in PS 2020 ('Communication and Approval'), the Head of Internal Audit will have to communicate the impact of resource limitations for delivery of the audit plan
- **Transfer:** Escalation to the AC could, after some detailed business cases and delicate negotiations with the wider senior management to gain executive support, eventually lead to some expansion of the IA function's budget. This could then open up a number of possibilities in transferring some of the resource management complexities to an external service provider as a co-sourced internal audit relationship. Co-sourcing can:
  - Flexibly allocate technical and specialist reviews, e.g., ESG and climate change financial risk, to external advisors that have the established contacts base and brand power to continuously recruit market-leading practitioners for targeted projects. Advisory firms also have the advantage of incorporating the lessons learned from the many reviews they carry out for their other clients
  - Help plug resourcing gaps within the existing IA function. In this manner, the in-house function continues to lead and deliver the audit plan, but is supplemented with staff to help progress high-volume activities, e.g., outcomes testing following implementation of the incoming consumer duty
  - Facilitate knowledge sharing from the advisory team's experts and, thereby, enhance the technical expertise (and confidence) of the in-house team to address more complex reviews. This is especially the case with data analytics – advisory teams have the advantage of dedicated IT, risk and modelling practitioners under one roof to help automate testing at scale or support implementation of analytics software, as well as the associated training and practical applications of the new tools (as the advisory firm uses them too)
  - Introduce the business to a wide pool of talent and advisory support that can go beyond internal auditing. As established advisory firms are also typically Skilled Persons, the collective knowledge of the co-source provider can address internal audit requirements and, provided independence is safeguarded, help the business resolve large-scale change management, remediation or regulatory projects.



EFFECTIVE RESOURCE MANAGEMENT

WHAT SHOULD INTERNAL AUDIT TEAMS THINK ABOUT?

Given Heads of Internal Audit and their IA activities vary in size, maturity, complexity and geographical spread (and the impact of Hybrid Working for IA is another article altogether), its not sensible to have a 'one-size fits all' approach for the unceasing resource management debates taking place in every IA function. That said, audit leaders navigating the business' growth and transformational periods will need to be proactive in assessing and responding to the changing environment with a coherent resource strategy which should at least include budget headroom for external expertise as and when required. Heads of Internal Audit need to consider:

- **Resource strategy and recruiters:** How would you achieve comfort that the IA resource requirements have been properly assessed, challenged and supported by a coherent resourcing strategy that encompasses all internally and externally available options? Who in the Executive management team will help you – Human Resources? Operations? 2LOD oversight teams, such as Risk, Compliance, Legal etc? Additionally, resourcing strategies would require a managed recruitment pipeline to pull talent into the function, rather than carpet emailing recruiters as soon as a resignation comes through. Ideally, working with HR to develop relationships with a handful of experienced, well established IA recruitment specialists can help the recruiter understand your function and anticipate who might need before the need comes up
- **Training and development:** What is the current training and development plan for the IA function and is it aligned to support the audit plan for next year and beyond? Are audit staff proactively approaching their own professional development – AS 1210 ('Proficiency') reminds us that individual auditors are ultimately responsible for their knowledge, skills and competencies to perform their roles, Heads of Internal Audit have to ensure that, collectively, the team's proficiency can land the plan or (AS 1210 A1.) obtain competent advice and assistance from external parties
- **Quality assessments:** The 2022 CIIA Benchmarking Report revealed that 34% of IA functions that responded to the survey have never conducted an External Quality Assessment (EQA) and that 18% confirmed an EQA was not being considered. Quality assessments, whether as an EQA, or self assessment supported by an advisor, could help unearth critical issues affecting resource management that are beyond the considerations in this article's analysis, e.g., is there a staff morale issue? Does the business value the IA function and perceives it as a supportive partner? Is the function keeping vigilant to the business' changing objectives? In some cases, we have seen resource issues as the symptom, not the cause, of difficulties within IA functions and, therefore, regular quality assessments, as well as an actively led quality assurance and improvement programme, can help resolve the bigger problems that eventually manifest as severe resource constraints on the plan.

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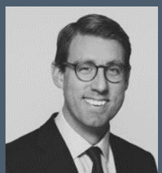
KEY RESOURCING TRENDS FOR INTERNAL AUDIT TEAMS IN 2023



ADAM JACKSON
Director, BDO Regulatory Solutions

KEY RESOURCING TRENDS FOR INTERNAL AUDIT TEAMS IN 2023

Being appropriately resourced is key for Internal Audit to operate effectively. The CIIA recently reported within Risk in Focus 2023:

"Boards should work with their internal audit function to evaluate whether the organisation's human resources strategies are aligned with its vision and mission, and whether they are suitable for these times of scarcity…"

It is also sobering to note that in a recent survey the CIIA stated:

"…36% say their budget must increase if they are to fulfil their responsibilities."

Given the budget constraints and skills shortages that many organisations are facing across key functions, the ability to access and deploy the required skills on an interim basis has become increasingly important.

This helps Internal Audit to respond quickly to changing priorities while giving a high degree of flexibility over spend.

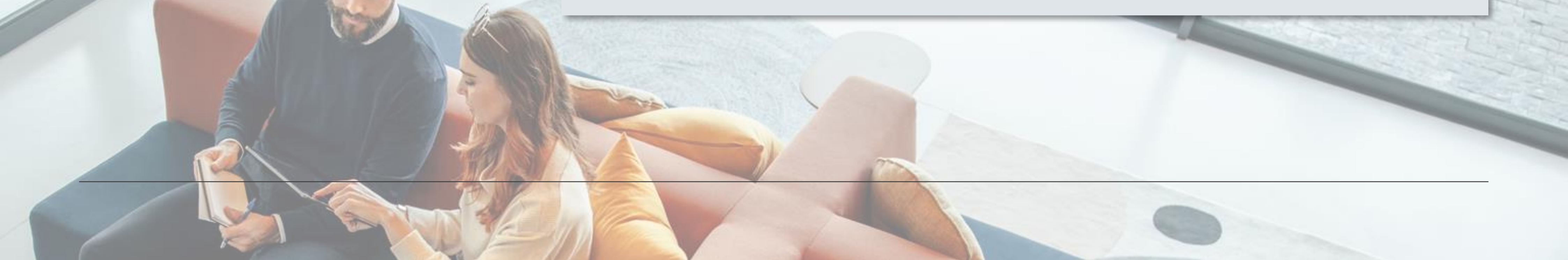
WHAT SHOULD INTERNAL AUDIT TEAMS THINK ABOUT?

In the Banking and Building Society sector, we are seeing the following trends in resource requirements from our clients:

- With the Consumer Duty implementation deadline fast approaching, assuring good customer outcomes is becoming critical. As a result, we are seeing the demand for skills in outcome testing substantially increase. This includes SMEs with the experience to design and improve frameworks, as well as teams of experienced outcome testers so firms can increase the volume of outcome testing carried out ahead of the July deadline
- The incoming Consumer Duty is also driving need for consultancy and project management support in helping clients successfully land their implementation of the new rules. For many firms, this is a transformational programme of cultural change which is increasing the need for change management and training resources
- Many clients are seeing a rise in customers facing financial difficulty and becoming vulnerable customers due to the ongoing cost-of-living crisis. This economic headwind is driving greater demand for practitioners who are skilled in collections and recoveries. This resourcing demand includes vacancies for experts to review existing processes and for increased numbers of frontline staff with the right aptitude and experience to deliver good customer outcomes
- With increased regulatory pressure on firms to prevent financial crime, we are reporting a surge in demand for experienced KYC/AML analysts. There had also been growth in financial crime training requests to upskill existing teams in carrying out the appropriate due diligence and screening processes throughout the customer journey.

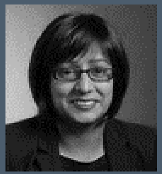
As discussed, above, in this monthly pack, the resourcing challenges for new and growing IA teams is multifaceted when we consider the determinants for efficient resource allocation, technical competency within teams, and recruiting professionals with a sound understanding of the regulatory landscape.

Whether sourcing individual SMEs for specific projects or providing a scalable interim team to deliver substantial change, we can help with all types of resource augmentation, secondments and programme management.



07

ECONOMIC CRIME UPDATE



SONIA DOHIL
Manager, Financial Services Advisory

ECONOMIC CRIME UPDATE

Last month, you will recall we looked at the Financial Conduct Authority (FCA) supervision and scrutiny of firms' AML systems and controls and fraud risk management.

Since then, there have been further developments in both that we will explore in greater detail, below. In addition we will cover Transparency Internationals Corruption Perceptions Index 2022 and The Wolfsberg Group Questionnaire Updates.

FCA SUPERVISION AND ENFORCEMENT ACTION

In early January, the FCA issued its first fines in 2023 for financial crime failures under Principle three ('A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems').

Whilst the sums have not been as eyewatering as some of those from last year, it is a reminder that, regardless of the size of the institution, the FCA is still undertaking enforcement action on the firms it regulates.

In these recent cases, the regulator had noted repeated weaknesses across both firms financial crime frameworks identifying a number of common gaps such as:

- Failure to carry out adequate enhanced customer due diligence on higher risk customers
- Failure to adequately establish, verify and evidence the source of funds and source of wealth for higher risk customers
- Failure to provide relevant staff with appropriate AML training.

WHAT SHOULD INTERNAL AUDIT TEAMS THINK ABOUT?

The FCA's Chief Executive Officer (CEO) Nikhil Rathi, had promised a more aggressive approach on money laundering. A stance that he reiterated in the FCA's 2022-23 Business Plan. As the FCA continues to utilise the tools at its disposal, and in line with the FCA's approach, it is expected that there will be greater scrutiny and action where firms are failing to maintain adequate financial crime systems and controls.

IA should ensure the 1LOD and 2LOD financial crime teams are appropriately reviewing the FCA's final notices and assessing the weaknesses identified by the regulator to be incorporated into the firm's enhancement of financial crime frameworks; for example:

- Firms should ensure that adequate enhanced customer due diligence procedures are in place and this is adequately evidenced for higher risk customers
- Firms should assess and review whether the source of funds and source of wealth for higher risk customers is adequately evidenced and that both are clearly understood by staff for these customers
- Firms should ensure procedures are detailed enough to allow staff to be consistent in their approach, to help the firm meet regulatory expectations
- Firms should ensure that staff are provided with appropriate AML training and any other additional training that is relevant to any other financial crime risk
- Financial Crime Compliance frameworks are ever evolving as firms grow and new risks emerge. Firms should ensure that such frameworks remain up to date and appropriate.

ECONOMIC CRIME UPDATE

NEW UK 'FAILURE TO PREVENT FRAUD' A CRIMINAL OFFENCE

The UK Government has recently confirmed that it intends to expand the Economic Crime and Corporate Transparency Bill with the introduction of an offence of 'failure to prevent fraud, false accounting or money laundering'. It is likely that a failure to prevent fraud offence would be enacted and it is estimated that the act will come into force in 2024.

It is expected that the failure to prevent fraud offence, will be similar to that of the 'failure to prevent bribery' under the Bribery Act 2010, and the 'failure to prevent the facilitation of tax evasion' offences within the Criminal Finances Act 2017. Any firm that fails to prevent fraud would be committing an offence. The only defence for firms would be to demonstrate that they had reasonable procedures in place to prevent fraud or that it was reasonable not to have such procedures in place. The new offence would allow for easier prosecutions of firms for involved in a fraud and for failing to prevent fraud being carried out by others.

WHAT SHOULD INTERNAL AUDIT TEAMS THINK ABOUT?

As fraud falls within the FCA's objective of reducing the risk of financial crime, it is expected that firms will have appropriate systems and controls in place to mitigate the risk of fraud. Internal audit teams are encouraged to review the firm's fraud frameworks to ensure that it covers:

- **Policies and procedures** - IA should provide assurance that fraud policies and procedures are risk based and aligned to the business, and that the firm's fraud risk assessment informs the controls designed
- **Top-level commitment** - The IA activity should evaluate governance processes to ensure that there is clear involvement from senior management in fraud risk prevention, especially in any key decision making for fraud frameworks
- **Risk Assessment** - Reviews need to be conducted on fraud risk assessments, examining internal and external fraud risks including any associated persons
- **Due diligence** - Assessments should ensure that due diligence procedures are in place for those who perform or will perform services for or on behalf of the firm
- **Training** - Firms will need to ensure that staff and, where appropriate, associated persons, are provided with fraud training using examples relevant to the firm and additional training is provided to those in higher risk roles
- **Monitoring and review** - Internal audit will also need to provide assurance that regular review and monitoring is in place to reduce the risk of fraud and identify any new emerging fraud risks.

ECONOMIC CRIME UPDATE

2022 CORRUPTION PERCEPTIONS INDEX (CPI)

Transparency International first published its CPI in 1995. It is in its 28th iteration, and whilst the 2021 CPI noted that corruption levels remained the same, the 2022 CPI noted that most countries are failing to stop corruption and scores for a signification number of countries had dropped down within the index.

The CPI ranks 180 countries 'on a scale from 100 (very clean) to zero (highly corrupt)' based on its position between 1 May 2021 and 30 April 2022. The CPI source data is built from a combination of at least three data sources drawn from 13 different corruption surveys and assessments. Transparency International states that these data sources are collected by a number institutions.

KEY CHANGES FOR THE 2022 CPI INCLUDE:

- Nine countries in the top 10 of the 'clean' countries for 2021 had dropped at least one level of rating, with one falling out of the top 10
- 72 countries dropped at least one rating level, including the United Kingdom with a significant drop of five levels
- 26 countries had fallen to its lowest rating to date
- 155 countries had made no significant progress against corruption or had declined since 2012.

It is clear that there a been a significant increase in corruption exposure across the global in the past year, and country risks have deteriorated in the current geopolitical climate. Transparency International highlight that low scoring countries have been unable to make significant progress in reducing corruption and those on the top had suffered from a lowering of standards and active enforcement of corruption.

WHAT SHOULD INTERNAL AUDIT TEAMS THINK ABOUT?

While firms are, understandably, focused on the regulatory requirements of the list of high-risk countries as set out in schedule 3ZA of the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017, firms should ensure that all key country risks are captured within a firms Country Risk Matrix (CRM). Internal audit teams should be working with their financial crime colleagues to effectively mitigate and manage country risks through the CPI:

- As part of the process for developing and maintaining an effective CRM and meeting FCA expectations, firms should utilise a range of country risk indications, such as the CPI, to enrich their country risk matrix
- Firms should also ensure that they annually reassess CRMs by incorporating updates to country lists reported in the CPI.

ECONOMIC CRIME UPDATE

THE WOLFSBERG GROUP QUESTIONNAIRE UPDATES

On the 10 February, the Wolfsberg Group released an update to its Correspondent Banking Due Diligence Questionnaire (CBDDQ v1.4) and its Financial Crime Compliance Questionnaire (FCCQ v1.2).

The CBDDQ v1.4 provides credit institutions with a comprehensive set of questions to assess cross-border and/or other higher risk correspondent banking relationship financial crime risks. The recent CBDDQ v1.4 updates include a new section on fraud and enhancements to questions relating to higher-risk customers, transaction monitoring, whistle-blower policy and data quality management. A number of other small changes included the design and usability of the questionnaire.

In addition, changes were made to the FCCQ v1.2 to ensure that the FCCQ v1.2 was consistent with the CBDDQ v1.4 providing a uniformed approach. The updated FCCQ v1.2, according to Wolfsberg, may be used by financial institutions to obtain high-level information about another firms' financial crime compliance programme where counterparty relationships exist.

The CBDDQ v1.4 and FCCQ v1.2 guidance notes have also been updated to address changes in the questionnaires. One of the key changes was around the timeframe firms can place reliance on. Previously it was expected that questionnaires would be updated annually. The recent update (12-18 months) has extended timescales to allow for a additional six month window, to align with due diligence review periods.

WHAT SHOULD INTERNAL AUDIT TEAMS THINK ABOUT?

- Where firms have correspondent banking relationships, or where counterparty relationships exist with the firm, then IA teams should check to ensure the firm is appropriately integrating the updated Wolfsberg questionnaires into its due diligence processes
- The IA activity should also check that the update to the firm's financial crime frameworks (such as policy and procedures) align the CBDDQ & FCCQ's with its due diligence review period for correspondent banking and counterparty relationships.

FOR MORE INFORMATION:

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