INTERNAL AUDIT SUPPORT

BANKING & BUILDING SOCIETIES

September 2023

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BDO

BDO FS INTERNAL AUDIT CONTACT POINTS

We hope you had a very enjoyable summer! Welcome to the Planning edition of our monthly packs. In this issue, we explore the sector's Hot Topics to be considered for the 2024 plan and revisit some of the regulatory priorities we've covered, such as Operational Resilience, to help Internal Audit teams appropriately address risks in their annual planning process.

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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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MEET THE TEAM

LEIGH TREACY
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 Leigh Treacy.

1. What has been your career leading into BDO?

After completing my university degree and qualifying as a Chartered Accountant, I joined KPMG in South Africa to complete my training contract, having worked for the firm over a number of years during my university holidays which gave me a great insight into professional services and the work I would be doing for the next three years and beyond.

I was absorbed into the world of banking and financial services, undertaking mostly external audit but also had some significant internal audit clients and special projects which gave me a view about solving client problems which was interesting and rewarding. I became a partner at KPMG in Johannesburg in 2006 and worked on large global accounts, which provided an international view in the lead up to the global financial crisis.

In 2010, I reached a point in my career where I was ready to make a change and moved to the UK where I joined Mazars as a partner and was involved in leading work on governance and culture in the Irish banking sector post-crisis which was fascinating and gave me a real flavour of advisory and consulting work.

I was approached to join BDO in 2014 to help build out the banking practice and took over the leadership of FS Advisory a couple of years later. The opportunity the firm offered me has been brilliant and has provided a great platform for me personally and for our business. I am now a member of the Advisory Executive which provides oversight and leadership of the One Advisory strategy across BDO, with responsibility for growing the FS business and executing our growth and investment plans, which are exciting.

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

I act as outsourced head of internal audit for some of our largest banking internal audit engagements as well as a large wealth and asset manager, amongst others. I also lead a number of co-sourced engagements. I work closely with audit committees and executives to help them solve business, risk and governance related issues. Quality delivery and introducing the right BDO teams to our clients is key for me - for us to be trusted business partners.

Beyond IA, I act as Skilled Person on a range of S166s and as QA partner, particularly in the risk, governance and prudential arenas, and also provide advice on risk and governance related matters.

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

I am in the process of refreshing the FS Advisory strategy, growth and investment plans and looking ahead to the next five years. Our multidisciplinary practice is hugely interesting with significant growth potential and thinking about how market changes, technology and regulatory influences keeps me on my toes. Key for me is ensuring we are thinking ahead, making sure we have the right people to deliver what our clients need - now and in the future - recruiting and retaining the best people to help us deliver. People are at the heart of our business and helping them develop their careers at BDO, and within FS Advisory in particular, is very close to my heart.

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

We have a great business and great people and continuing to build on the work we do is rewarding. We have a great reputation and I am proud of that.

5. What drives you to do what you do?

I am a driven person, and that means for me that I am focused on leading a successful part of the BDO business and supporting my partners and teams to achieve personal success - whatever that looks like for each of them. The BDO strapline - 'helping you succeed' - resonates with me, both for our people and our clients.

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

Each day in professional services is different, and that really is the beauty and attraction of it. There is simply no opportunity to stand still or be bored! I look back sometimes and reflect on the last 25 or so years and the variety and range of interesting work and people I have dealt with really has added colour to my career and professional and personal experience and learning. It continues to be a brilliant journey.

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

Always be sure to understand the facts, prepare thoroughly and work hard and the results will follow. Your reputation is everything, and is built on the quality of work you deliver and the professional relationships you build.

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

Data analytics and technology are developing at pace, as well as other AI related tools. We need to understand these and adapt our methodologies to leverage the efficiencies they bring as well as the ability to benchmark and draw insights. These developments offer us the opportunity to add even greater insights for our clients.

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

If I was to choose three things, they would probably be gardening, cooking and travel. I have four grown up stepchildren and three grandsons (with another on the way) so keeping in touch with them is often a weekend highlight.

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

A means of escape! My husband, Tony, who is very practical and prepared for anything, a powerful boat and a good tent.

02

AUDIT PLANNING

HOT TOPICS TO BE CONSIDERED FOR THE 2024 PLAN

PAUL GILBERT
Director

AUDIT PLANNING

Hot Topics to be considered for the 2024 plan

Topic	Overview	Drivers	Indicative Scope Areas
Customer Support Offering and Arrears Management	Assessment of the proactive strategies and reactive arrangements to support borrowers who encounter financial difficulties	High inflation and rapid increases in interest rates adding significant pressure to borrowers now and in future as fixed rate term mortgages mature.	• Assess firm's implementation of customer support measures • Assess arrears management process and controls • Consider how internal resource requirements have been determined and managed to allow the Firm to respond to borrowers who seek support or encounter financial difficulties • Key risk indicators and performance metrics to track progress and performance • Proactive support and contact strategies
Cyber Security	Establishing an effective internal audit universe and strategy for delivery of a programme of internal audit activity to assess the control framework for cyber security	Important and high-risk area as a result of: • Digital innovation and cloud-based strategies by Firms changing the cyber risk profile of firms • Elevated cyber security threat levels and many well-known examples of cyber security incidents make this a key area for coverage and Audit Committee focus • Implications for customers in the event of an incident • Regulatory importance as a component of operational resilience.	• These need to be determined taking into account the digital strategy and wider assurance activity in relation to cyber security. • As such, internal audit departments can add value by developing a cyber risk assurance strategy that provides Audit Committee with a clearly defined and sequenced programme of activity over time (e.g., a three-year strategy) that is aligned to the strategic development of systems and IT infrastructure and is prioritised according to the cyber risks applicable to the bank or building society and takes into consideration other assurance available.
Digital Innovation	Establishing an effective internal audit strategy for providing assurance on the governance and control framework for digital innovation programmes and / or individual projects.	Developing the digital offering for customers is often a key strategic priority and is important to the customer proposition and can also deliver cost and efficiency savings.	The role of Internal Audit for major transformation activity will typically be multi-faceted and will adopt a continuous assurance and 'critical friend' role to evaluate the governance and control framework that is adopted to achieve the strategic objectives. This is likely to include a combination of reviews relating to the design and operating effectiveness of controls at different levels; • the intended governance and control framework; • the operation of the governance and control framework for the major transformation initiative(s); and • evaluating the progress and outcomes associated with major transformations initiatives (deep-dive).

AUDIT PLANNING

Hot Topics to be considered for the 2024 plan

Topic	Overview	Drivers	Indicative Scope Areas
Consumer Duty Post-Implementation	Assessment of firm's implementation and embedding of the requirements and expectations associated with the Consumer Duty.	The FCA published its policy statement and finalised guidance on 27 July 2022. These set out a number of deadlines relating to implementation of the rules. The key dates included: • Boards to scrutinise and agree implementation plans by 31 October 2022; • Rules implemented for existing products and services by 31 July 2023; and • Implementation date for back book by 31 July 2024	• Assess adherence to the governance and control framework to deliver and embed the Consumer Duty requirements. • Assess process and controls to ensure clear and timely customer communication., • Assess process to identify where and why a customer may not be receiving a good or desired service, and proactively address any risks or issues identified during this process. • Assess the management information and reporting that has been developed to ensure ongoing compliance and customer outcomes.
Operational Resilience	Assessment of a firm's operational resilience framework to prevent, adapt, respond to and recover from operational disruption	By the 31 March 2025, firms must be able to evidence they can remain within the impact tolerances for each of their important business services. A review in Q4 2024 would give sufficient time to assess readiness and time to meet any findings before the deadline.	Key audit areas to be assessed are; • Approach / Methodology • Self-Assessment including: ○ Important Business Services ○ Mapping (People / Processes / Technology etc.) ○ Impact Tolerances ○ Scenario Testing • Policies & Procedures • Governance Arrangements including SMCR implication e.g., SMF24 oversight & responsibility.
ESG	Assessment of the plan / strategy developed by Management in relation to ESG	Increased consumer, market and regulatory focus, awareness and scrutiny on ESG matters.	• Assess ESG framework is in place and that the firm's vision, values and strategy is aligned. • Assess adequacy of ESG reporting including environmental, social, and governance aspects of a business. Social to include D,E & I. • Review firm's assessment of ESG related risks and KPIs. • Assess adherence to ESG regulations and related reporting requirements, such as FCA's Task Force on Climate-related Financial Disclosures (TCFD), Companies Act 2006, Modern Slavery Act 2015 and Equality Act 2010.

AUDIT PLANNING

Hot Topics to be considered for the 2024 plan

Topic	Overview	Drivers	Indicative Scope Areas
Talent Management	Assessment of the governance and controls framework associated with processes to attract, identify, develop, engage and retain	This continues to be a key area where we see Firms and HR functions experience challenges in retaining and securing the staff and leadership capability and experience that they require. This reflects changes in technology and working practices which are reshaping the way people work, learn, collaborate, manage and inspire teams.	• Staff sourcing and resource solutions • Performance management • Staff engagement and retention • Career development and progression • Diversity and inclusion • Succession planning
Capital and Liquidity Management	Evaluate the governance and control framework to ensure that capital and liquidity risks are assessed and managed and that regulatory requirements are met	The changing economic landscape, with higher interest rates and the increased ability of customers to manage money digitally has implications for capital and liquidity risk management and creates a need for a robust assessment, quantification and management of liquidity and capital risks.	Internal Audit strategy to give consideration to the timing of ICAAP and ILAAP documents to the Prudential Regulation Authority and to evaluate how capital and liquidity risks are managed on an ongoing basis.
Model Risk	Assessment of the implementation of model risk management standards.	The Prudential Regulation Authority has published PS6/23 - Model risk management principles for banks. This will take effect from Friday 17 May 2024.	• Model identification and model risk classification • Model governance • Model development, implementation and use • Independent model validation • Model risk mitigants

03

QUALITY MATTERS
PART 5

PRODUCING AND MANAGING AN EFFECTIVE QAIP

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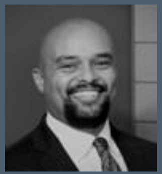
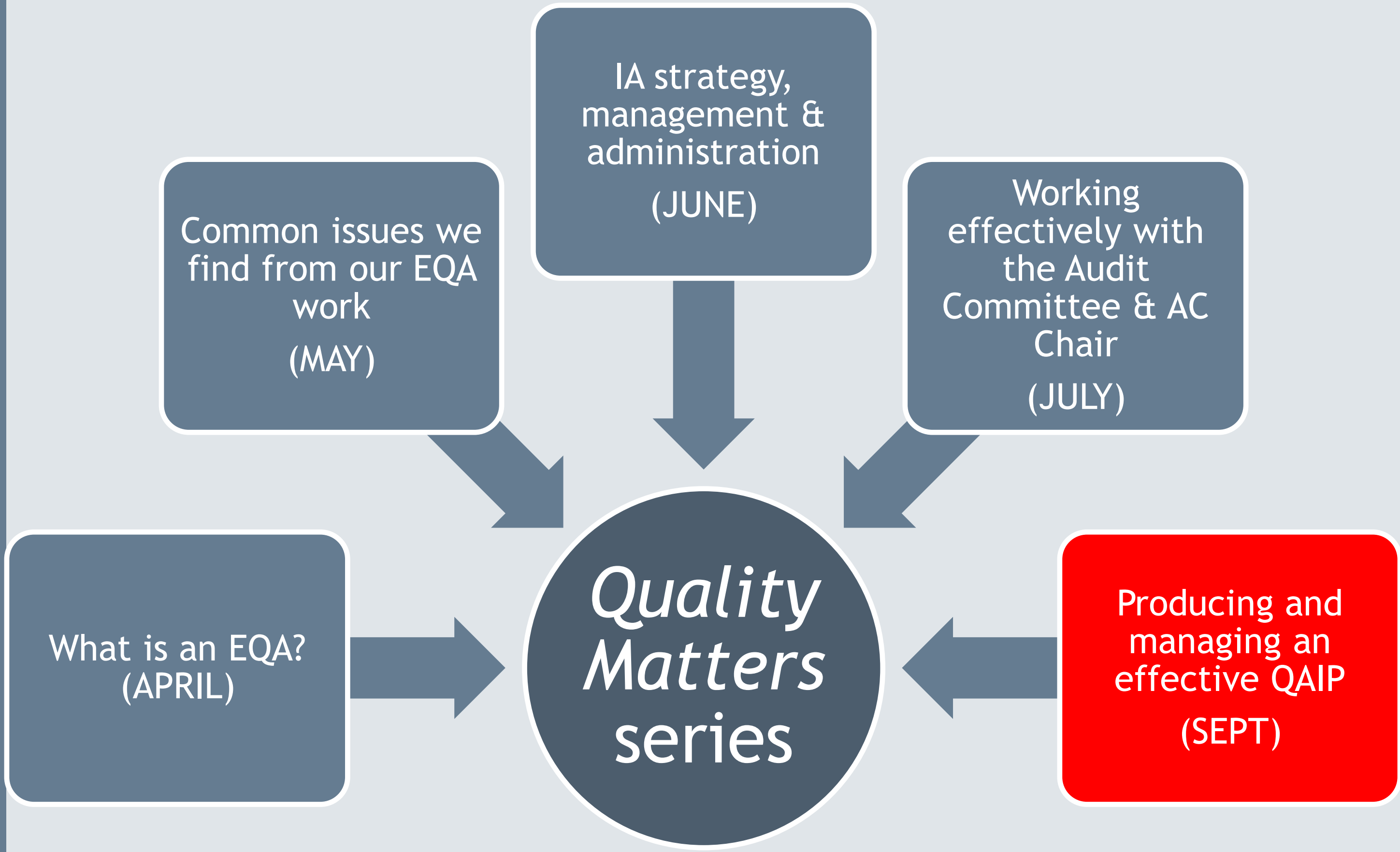
Partner



BRUK WOLDEGABREIL
Associate Director



QUALITY MATTERS - PART 5

Producing and managing an effective QAIP

In our July pack, we explored the dynamic relationship between the Head of Internal Audit (HoIA) and Audit Committee (AC), especially the AC Chair, that we've typically picked up on from our EQA engagements.

This month, we explore good practices for producing and managing a Quality Assurance and Improvement Programme (QAIP) based on insights gathered from our EQA and quality assurance work.

In essence, the QAIP is a programme of activities designed to evaluate the IA activity's conformance with the Standards, the Definition of Internal Auditing and how individual auditors apply the Code of Ethics. Aside from conformance measures, the QAIP also assesses the effectiveness and efficiency of the IA activity (i.e., is it landing the IA strategic objectives as much as delivering the plan) and identifies opportunities for continuous improvement.

BREAKING A QAIP INTO ITS KEY COMPONENTS AND GETTING THE TOOLS READY

As a refresher, the Head of Internal Audit:

"…must **develop** and **maintain** a quality assurance and improvement program that covers **all aspects of the internal audit activity**" (AS 1300 – emphasis added).

To better understand the scope and scale of activities expected within such a programme, we should unpack the key components of this Standard as follows:

- Development;
- Maintenance;
- Its applicability to all aspects of the activity.

Before we explore each of these aspects in greater detail, further below, we should first identify all the relevant sources of information and tools to appropriately prepare a HoIA before a QAIP is produced.

Must haves (mandatory)

The "mandatory" elements of the International Professional Practices Framework (IPPF) which includes the IIA's:

- Standards;
- Code of Ethics;
- Core Principles (can you remember all 10 of them?); and
- Definition of Internal Auditing.

For UK financial services firms, there are additional requirements from the CIIA's FS Code (specifically Part G) which adds further guidance on the QAIP to drive an effective Internal Audit activity.

Should haves (recommended)

Outside of the mandatory elements, there is the IIA's:

- Implementation guidance for Attribute Standards 1300, 1310, 1311, 1312, 1320, 1321 and 1322;
- Supplemental guidance; and
- Practice Guides – there are quite a few. Some may appear a bit dated, but you'll see from review that the key principles for auditing today have stood the test of time. Below are a couple that should be prioritised for recommended reading:
  - "Quality Assurance and Improvement Program" (US spelling for a US title)
  - "Assisting Small Internal Audit Activities in Implementing the International Standards for the Professional Practice of Internal Auditing" (very useful advice for applying proportionate conformance to Standards for small IA functions– more on this below)

QUALITY MATTERS - PART 5

Producing and managing an effective QAIP

Could haves (going all in for best in market practice)

The IIA also has a Quality Assurance manual based on the current 2017 Standards. It is comprehensive, at nearly 400 pages, with recommended process flows, roadmaps, templates etc as well as the mandatory elements, noted above.

Whether a HoIA feels they need this manual should first assess the complexity and scale of their IA activity to ensure a proportionate approach is applied. In most small to medium sized IA functions, there is a significant challenge in getting the basic (mandatory) elements of the QAIP in place due to limited staff, resources and time available just to deliver the audit plan.

This article will focus principally on the mandatory components and some of the good practices noted from our work with clients on EQAs that we can reference within IIA guidance.

DEVELOPMENT OF THE QAIP

The QAIP should include:

- **Ongoing monitoring** – day-to-day supervision and review of auditing activity at the engagement level, i.e., planning, fieldwork and reporting follow established policies and procedures (which themselves conform to the Standards);
- **Periodic self-assessment** – which can either be an in-house self-assessment or a self-assessment with independent validation, which would include an independent third party to help facilitate an effective self-assessment. The benefit of an independent third party is that it can apply the objectivity and independence that comes with a fresh pair of eyes on the IA activity's self-assessment and, dependent on the experience of the QA provider, an opportunity to benchmark expectations against comparable functions elsewhere;
- **External Assessment** - principally EQAs, but could also encompass a variety of outsourced QA support, such as ongoing sample and review of audit files to the IA activity's quality expectations. This could be hugely beneficial for small IA teams, e.g., less than 5 staff members, that need a proportionate QA of files but are stretched to prioritise delivery of the plan. Outsourced assessors can also facilitate knowledge transfer through post-QA training to staff which can incorporate the good practices gathered from other IA functions the assessor has worked with.
- **Continuous Improvement of the QAIP** – which is the feedback loop to incorporate the findings, recommendations and follow-up activities from QA work back into the programme, thereby evolving the management of quality over time (much like a turbo charger injecting exhaust back into the car engine to increase power).

The HoIA will need to develop the programme, and reporting of its outputs to the AC, in line with scale and complexity of the IA activity and budget. As we've explored in previous editions of this monthly update, where resources are limited in delivering the audit plan these limitations (including the resources required for a proportionate QAIP) must be communicated to the AC as soon as practicable.

There would be no point in delivering an audit plan only to find that there were little to no safeguards in place to assure the quality of the function's operations and outputs.

MAINTENANCE OF THE QAIP

While aspects of the programme can and, in most cases, should be outsourced to experienced QA providers, the maintenance of the QAIP sits squarely with the in-house HoIA and (ideally) their successor in waiting.

From our EQA experience, an IA activity that has developed an effective QAIP is generally maintaining it with some external expertise and a deputy / successor to the HoIA being delegated to lead its operation, especially supporting the HoIA in driving the continuous improvement activities and appropriately evolving the IA strategy. For the HoIA, this would have two clear benefits:

- Empowers a deputy/successor keen to take on more responsibility, receive senior coaching and development from the HoIA and develop the technical expertise to support their case for taking on the HoIA role if the opportunity arises;
- Provides the HoIA capacity to take a 50,000ft view of the programme and reflect strategically on what the QAIP assessment outputs are telling him/her about their function, i.e., is it effective, efficient, adding value above and beyond audit reports, is meeting the expectations of senior management and the Board?

QUALITY MATTERS - PART 5

Producing and managing an effective QAIP

QAIP - ITS APPLICABILITY TO ALL ASPECTS OF THE ACTIVITY

The programme should encompass three critical aspects of the IA activity:

- **IA Governance** - which includes the Charter, IPPF, CIIA FS Code requirements, independence and objectivity requirements, and the resourcing strategy;
- **IA Professional Practice** - which brings together risk-based auditing (the function's manual, procedures), reliance on other assurance providers, delivery on the basis of the established procedures (planning and fieldwork), auditor proficiency and due professional care and QA activities, e.g., file reviews, post-review supervisory appraisals or auditee feedback surveys;
- **Communication** - including reporting of results, action tracking and closure and the quality of stakeholder engagement.

The focus we have found in some IA functions is on the professional practice areas, where evaluation against established audit policies and procedures is relatively straightforward, i.e., assessing a file against a checklist of consistent requirements to see if all the "boxes have been ticked". But this misses the value from periodic review of Quality within the critical areas we have explored in this series of articles, including:

- April - Audit planning and action tracking
- May - Maximising the benefits of an external assessment
- June - IA strategy, management and administration matters, including challenges to independence in smaller IA activities
- July - Stakeholder engagement, especially with the AC Chair and AC

WHY QUALITY MATTERS - WHAT SHOULD HEADS OF INTERNAL AUDIT THINK ABOUT?

We'll conclude this series as it began: "Quality" could be defined as the degree to which a product or process meets its expectations. Therefore, it's no surprise that the IIA places substantial emphasis on the importance of a well-established QAIP, including periodic self-assessments, and an external assessment at least every five years to ensure that the IA function is operating to a sufficient level of quality.

Just before the COVID pandemic, the former Global IIA President, Richard Chambers, gave a useful speech in which he emphasised the various benefits of EQAs. Within his remarks, he cautioned against the perception, or use, of EQAs as "weapon against practitioners who are simply doing their jobs"; EQAs, as well as other forms of outsourced QA support, should signify to stakeholders that an internal audit function operates at a high level of ethical and professional competencies.

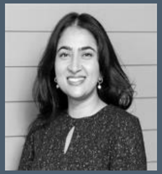
This article forms the last instalment of our "Quality Matters" series - we hope that you found our EQA-driven insights and good practices helpful.

To build upon this series and address broader areas of interest for the NED community regarding EQAs and Quality Assurance, we will be presenting to the BDO Financial Services NED Club on 29 November.

If you are an AC Chair, member of an AC or have Board oversight over your firm's risk and control framework please contact our colleague Rima Stephenson about this event: Rima.Stephenson@bdo.co.uk

04

OPERATIONAL RESILIENCE - WHERE ARE WE NOW?



KARUNA BHANDERI
Director

OPERATIONAL RESILIENCE

In our last update on this topic (July 2022), we set out some key areas for firms and their Internal Audits to be thinking about when considering their arrangements for Operational Resilience and how this relies on a robust framework for Outsourcing.

Subsequently, firms have continued to operate in a complex environment both in the UK and in the wider geopolitical context. The increase in digitalisation, and rapidly expanding use of AI, present higher hurdles to firms' operating environments and operational risk management. Regulators remain clear that severe and prolonged disruptions to important business services will not be tolerated.

Although the next regulatory deadline specifically linked to Operational Resilience is over a year away, there remains work to be done to ensure this can be met. Firms have until March 2025 to complete their Operational Resilience mapping with a view to be able to remain consistently within their approved impact tolerances. This can be a straightforward exercise for IBSs that are undertaken internally; however, where third-parties are involved, this can present a challenge as these relationships can be more complex, deeply rooted, long-standing or intra-group.

RELIANCE ON OUTSOURCED AND THIRD-PARTY SERVICE PROVIDERS

As a reminder, to meet regulatory expectations, firms are expected to:

- Include relevant third parties within the firm's operational resilience mapping;
- Assess them for potential vulnerabilities; and
- work with them to ensure the validity of the firm's scenario testing or, to the extent they rely on the suppliers' testing, to ensure the suitability of the methodologies, scenarios and considerations adopted to carrying out testing.

The possibility of a cyber-attack is a key threat that the FCA has emphasised within its expectations of firms' scenario testing plans. Therefore, it is logical to consider this a critical area of regulatory focus to identify any possible vulnerabilities faced by outsourced and third-party service providers. Firms should understand the nature and depth of the cyber security arrangements and scenario testing that the third party may have completed themselves and satisfy themselves that it is sufficient.

The FCA has confirmed that if firms are unable to obtain sufficient information and assurance from a third-party supplier to satisfy themselves that the third party can operate within the determined impact tolerance(s), then the firm should review and, if necessary, change its outsourcing arrangements.

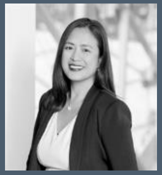
OPERATIONAL RESILIENCE

WHAT SHOULD INTERNAL AUDIT TEAMS THINK ABOUT?

- **Ongoing Implementation / Project Management:** Many firms implemented Operational Resilience via a regulatory change project to meet the March 2022 deadline, but firms are approaching the transition period differently. Some firms have transitioned these activities to be completed as part of BAU while others are moving to a new project, or second phase to meet the March 2025 deadline. Irrespective of approach, the FCA were very clear that firms should not wait until the end of transitional period to be able to remain within their impact tolerances, but rather remain within them as soon as reasonably practicable within the 3-year transition period. Internal Audit reviews in the latter half of 2024 will be crucial to assess whether the requirements will be met in time for the deadline and leave sufficient time for potential enhancements to be implemented.
- **Impact of combined or multiple disruptions**: Firms should be considering scenarios where there might be disruption to multiple resources underlying an IBS and what the collective impact of these might be. Inadequate resource mapping or narrow scenario testing may not cover concurrent failures, and this could lead to a firm not being able to remain within tolerances.
- **IBS Mapping**: An assessment of the depth and coverage of the mapping completed for each IBS will be crucial to evidence that due consideration has been given not just to internal processes but also to outsourced, and third-party providers. If not already planned, internal audit reviews of outsourcer and third-party management would support ongoing operational resilience work. The FCA believe they have provided an appropriate amount of time to allow firms to embed the changes that may be necessary within their business, including to make appropriate investment to help embed operational changes. It should also be noted that the March 2025 is a hard deadline and a firm that is not making reasonable effort to remain within its impact tolerances during this transition period would be in breach of the FCA's rules.
- **Scenario testing**: Scenario testing will be an on-going activity and expected to be conducted on a rolling basis depending on a combination of factors tailored to the scale and complexity of the firm. These factors are likely to include the associated risk, likelihood of failure, or be event driven. We expect that the regulators will be looking for a scenario testing plan that is on a schedule with clear rationale as to the frequency and nature of testing. Looking ahead will provide comfort that appropriate coverage, focus, and resource will be allocated to this activity. Lessons learned are also a key part of this and properly scheduled scenario testing can tell a strong story of refinements to the control environment.

05

PRUDENTIAL RISKS



AIZA MARIE SACE
Senior Manager

PRUDENTIAL RISKS

Earlier this year, the PRA unveiled its priorities for UK deposit takers and banks active in the UK. Amongst a number of priorities, the prudential risk considerations for senior management teams included financial resilience, regulatory reporting, resolution, and resolvability assessments.

In this article, we examine the regulatory expectations of firms to manage these risks and what we have gathered as insights from our advisory work that could support your annual internal audit planning process.

FINANCIAL RESILIENCE

Certain segments of the global financial system remain vulnerable to pressures, with threats arising from factors such as a weak economic outlook, persistent high inflation, and geopolitical tensions. The year has seen:

- the collapse of three banks, including Silicon Valley Bank in the US and Credit Suisse in Switzerland;
- central banks worldwide have been raising interest rates to combat inflation, with the BoE notably increasing its rate from 0.1% to 5.25% (at the time of writing) since December 2021;
- rising living costs and higher interest rates are challenging households, while the Bank of England (BoE) anticipates that more businesses will allocate a significant portion of their income to debt servicing.

The combination of the aforementioned factors heightens the potential risks that banks and building societies may face in terms of losses.

Regulatory Focus: The PRA's primary objective is to ensure that financial institutions under its supervision possess the necessary resilience to withstand various challenging scenarios without endangering overall financial stability. This entails setting requirements for capital and liquidity, empowering firms to navigate obstacles, and surmount barriers. The PRA also emphasises stress testing, capital adequacy, and risk management to enhance financial resilience.

The UK Counter Cyclical Capital Buffer, currently set at 2%, serves as a protective measure. This buffer allows banks to absorb potential losses without hindering lending to the broader economy.

To gain a better understanding of how financial institutions behave during market stress, the BoE introduced the system-wide exploratory scenario (SWES) exercise. This initiative explores how such behaviours could interact to amplify shocks within the UK financial markets. While the UK banking system is deemed well capitalised and maintains substantial liquidity buffers, the challenging overall risk environment necessitates ongoing efforts to enhance resilience.

PRUDENTIAL RISKS

REGULATORY REPORTING

Regulatory reporting plays a critical role in financial oversight, offering regulators vital data to monitor institutions' financial health and assess their adherence to regulatory standards. Regulatory reports encompass a wide range of submissions, including responses to ad hoc inquiries, COREP and FINREP returns, and BoE statistical returns.

In September 2021, the PRA issued a "Dear CEO" letter containing thematic conclusions on UK banks' regulatory reporting standards. The PRA expects banks to apply the same accuracy, oversight, and rigour to regulatory reporting as they do to financial reporting. The PRA's 2023 priorities letter highlighted deficiencies in data controls, governance, systems, and production controls for regulatory reporting.

Effective regulatory reporting requires robust procedures, improved monitoring, professional interpretation of legislation, and meticulous record-keeping to overcome common challenges like weak data infrastructure, outdated systems, lack of expertise, poor governance, complex data issues, weak controls, errors, diverse regulatory interpretations, and insufficient documentation.

Regulatory Focus: The PRA's 2023 business plan emphasises advancing data and technology initiatives, including the Banking Data Review to modernise regulatory reporting. The review aims to align collected data with supervisors' needs, streamline collection processes, and ensure readiness for future responsibilities, including Basel 3.1 standards implementation. The Transforming Data Collection Programme also contributes to enhancing data collection practices.

The PRA's revised banking supervision approach incorporates Section 166 (Skilled Persons) Reports and highlights that the skilled person reviews of data controls, governance, and systems for regulatory reporting will be utilised to reduce the gap in regulatory reporting.

RESOLUTION

On July 30, 2019, the BoE and the PRA introduced the Resolvability Assessment Framework, outlining essential capabilities for firms to ensure their own resolvability. This framework details the BoE's approach to evaluating resolvability, mandating major UK firms to self-assess their readiness for resolution.

The PRA's focus on resolution revolves around creating systematic frameworks and strategies for the orderly resolution of struggling banks. Firms must ensure they achieve and maintain the resolvability outcomes outlined in the Framework, transparently disclosing their resolution preparations.

The collapse of Silicon Valley Bank underscores the importance of resolution in preventing financial crises. The successful resolution of Silicon Valley Bank UK Limited marked the BoE's first use of resolution measures since 2009, highlighting the critical role of resolution planning.

PRUDENTIAL RISKS

Regulatory Focus: In its "Dear CEO" letter for 2023, the PRA stresses that firms under the Resolvability Assessment Framework (RAF) should align with its objectives. On June 28, 2023, the PRA released a consultation paper advising non-systemic banks and building societies to prepare for and execute solvent exits from PRA-regulated activities.

In 2022, the BoE assessed the readiness of the primary UK banks for potential resolution under the Framework. It will continue appraising major UK banks in 2024 and subsequently every two years, aiming to monitor advancements and enhance preparedness for resolution. This aligns with the Bank's objective of maintaining a robust resolution framework for financial stability and market discipline.

On April 18 2023, the BoE published a statement on enhancing depositor outcomes in insolvency scenarios. This effort involves collaborating with financial authorities and industry to explore technology solutions, ensuring depositor protection and minimising disruptions.

In June 2023, the European Banking Authority (EBA) released final Guidelines for testing resolvability, transitioning towards practical implementation. The Guidelines mandate complex banks to create a comprehensive Master Resolution playbook and undertake multi-year testing.

WHAT SHOULD INTERNAL AUDIT TEAMS THINK ABOUT?

Firms should integrate the aforementioned priorities into their risk management framework and overarching strategy. This might entail revising current risk management approaches and associated documentation such as the risk appetite statement, ICAAP, ILAAP, and recovery plan.

Internal Audit teams should consider the level of assurance placed on the bank’s regulatory reporting processes, ensuring infrastructure, controls, and governance align with regulators’ expectations.

There should also be a focus on evaluating policy alignment with regulatory requirements and ensuring 2LOD teams are implementing robust staff training, which will aid in prompt default detection and compliance monitoring.

PRUDENTIAL RISKS

Solvent Exits

On 28 June 2023, the PRA released a consultation paper advising non-systemic banks and building societies to prepare for and be able to successfully execute a solvent exit from PRA-regulated activities.

WHAT IS A SOLVENT EXIT?

PRA defines solvent exit as a bank or building society ceasing deposit-taking activities while remaining solvent. Firms must transfer or repay deposits as part of a solvent exit, and the exit ends with removal of the firm's Part 4A PRA permission.

Summary of the PRA's Proposals:

- Planning for a solvent exit as part of BAU activities: The proposed rules mandate firms to plan for a potential solvent exit as part of their regular business operations and maintain a solvent exit analysis. The aim is to ensure firms can smoothly and promptly discontinue PRA-regulated activities when needed. The proposed expectations are intended to assist firms in identifying risks and barriers, making timely decisions, and reducing costs and lack of preparedness.
- Once solvent exit is a reasonable prospect: The PRA is proposing new expectations for firms considering a solvent exit, outlining the steps they should take. These expectations include producing a detailed solvent exit execution plan and executing and monitoring the exit. Firms must provide the plan to the PRA, showing that they can successfully execute the exit. Throughout the process, firms are required to keep the PRA and other stakeholders informed and continually monitor the execution. The proposals aim for effective and timely solvent exits, fostering clear decision-making, communication, and monitoring for successful outcomes.
- Proposals for consequential changes to SS3/21: The consultation paper also outlines proposals to modify SS3/21 for new and growing banks. It recommends substituting the term 'solvent wind-down' with 'solvent exit' when describing the cessation of PRA-regulated activities while solvent. The main objective is to introduce clearer and more accurate language regarding the process of ceasing PRA-regulated activities while ensuring solvency.

WHO DOES THIS APPLY TO?

The CP applies to: (a) UK banks and building societies not subject to the Operational Continuity Part of the PRA Rulebook; or (b) not members of a global systemically important institution(G-SII) or any other systemically important institution (O-SII). It is also not relevant to credit unions or branches of third-country groups.

NEXT STEPS

The proposed changes, if implemented, will necessitate firms to comply with the newly introduced rules and expectations outlined in the Recovery Plans Part of the PRA Rulebook and the accompanying supervisory statement. Moreover, firms are encouraged to provide feedback on the proposals during the consultation period, which concludes on Friday, 27 October 2023. Preparations for implementation should be made for the proposed changes anticipated to take effect in Q3 2025.

Firms should also consider the estimated costs and benefits associated with implementing the proposals and ensure compliance with relevant statutory obligations applicable to the PRA's policy development process. Keeping abreast of further updates or guidance from the PRA regarding solvent exit planning is equally essential.

WHAT SHOULD INTERNAL AUDIT TEAMS THINK ABOUT?

Solvent exit planning is the most common exit route for non-systemic firms and the PRA has found that some exits have been challenging and, in some cases, protracted. Issues affecting an orderly exit were only discovered during the execution of the exit. The PRA recognises that firms can further enhance the planning in order to execute the exit in a more efficient, cost effective, and successful manner. The PRA, furthermore, believes that greater preparedness by firms for a solvent exit would support the PRA's statutory objectives and should benefit firms and by reducing disruption to the wider market.

Internal Audit's planning should consider the following activities:

- The comprehensiveness and applicability of the level of detail in the solvent exit analysis as proportionate to the nature, scale and complexity of the firm's business operations.
- The plausibility of circumstances and scenarios identified that could lead to firms needing to execute a solvent exit.
- Adequacy of governance and oversight to ensure that solvent exit results in a higher probability of success, facilitate a more efficient exit and reduce the risk of losses to firms.

06

ESG UPDATE

INTEGRATING CLIMATE CHANGE INTO THE ICAAP

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ESG UPDATE

Integrating Climate Change into the ICAAP

UK banks are under increasing regulatory pressure to manage and report their exposures to the climate crisis, protect themselves from the impact of climate change and to align with clients' shifting attitudes towards greener economies, sustainability, and governance factors in their investment decisions.

Over the last few years, UK and EU regulatory authorities have been tightening their grip on Environmental, Social and Governance ("ESG"), issuing various publications calling banks to implement their ESG strategy and risk appetite in a timely and decisive manner with the objective to ensure viability of the bank's business model.

The PRA encourages UK banks to capture its ESG risks through manging climate change risks as early as possible with the intention that banks take a strategic, holistic and long-term approach, considering how climate-related risks could impact all aspects of their risk profile.

Climate change risks are considered as financial risks, and banks will need to understand the impacts in terms of both physical risk and transition risk under various scenarios.

To manage these risks, the PRA expects banks to have taken action in specific areas, set out in publications such as PRA SS3/19 'Enhancing Banks and Insurers Approaches to Managing the Financial Risks from Climate Change,' and the 2021 Biennial Exploratory Scenario ("BES"), highlighting the risks that rising temperatures and sea levels could pose for the financial system, as part of the Bank of England's climate stress tests.

The PRA's latest thinking on climate risks set out in the 'Prudential Regulation Report on Climate Related Risks and the Capital Framework 2023,' considers climate related modelling for calculating Pillar 1 Risk-Weighted Assets ("RWAs").

INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS ("ICAAP")

In the first instance, banks should have in place climate change tool kits including strategies, road maps, target operating models, management resources and action plans which would help build out their climate change framework.

As part of the ICAAP, the PRA expects banks to include all material exposures relating to the financial risks from climate change and an assessment of how the bank has determined these exposures in the context of their business model.

The level of integration of climate change in the ICAAPs should cover:

- How the Board sets out the tone on climate-risk governance. The Board will need to demonstrate that it has the right knowledge and tools to provide oversight responsibilities in accordance with the bank's business strategy and risk appetite, and is supported by appropriate governing arrangements;

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Integrating Climate Change into the ICAAP

- How the Board sets out the tone on climate-risk governance. The Board will need to demonstrate that it has the right knowledge and tools to provide oversight responsibilities in accordance with the bank's business strategy and risk appetite, and is supported by appropriate governing arrangements;
- How senior management holds a strategic view of the material climate related risks facing the bank and take responsibility for climate risk management to be cascaded throughout the bank;
- Alignment of climate risk exposure with risk appetite and business strategy. Senior managers should embed climate risk into their capital allocations, loan approvals and portfolio monitoring processes;
- How banks consider holding additional capital to cover risks from climate change;
- How risk management frameworks identify, measure, mitigate, report and manage climate risks;
- Scenario analysis and stress testing should develop a range of plausible events and test the resilience of climate change to the bank's business model;
- Risk appetite should be adjusted to accommodate climate change to the bank's risk profile;
- Banks should describe how managing climate change risks is expected to create opportunities, both on the product and on the funding side;
- Banks will need to demonstrate appropriate tracking of climate risk metrics and net zero targets; and
- Pillar 3 Disclosures for market transparency.

CHALLENGES

There are a number of common challenges facing banks when they seek to integrate climate change risks into their ICAAPs. Here are a few that we've picked up on from our advisory work:

- Level of Board and senior management expertise;
- Availability of respective data for managing climate risk;
- Ability of accurately capturing climate risk exposures on the bank's balance sheet;
- Integration of climate risk into front-to-back activities;
- Availability of high-quality MI to the Board;

ESG UPDATE

Integrating Climate Change into the ICAAP

- Interaction of climate change risks with current risk types;
- Managing climate change risks will require banks to make qualitative judgements;
- Integrity of climate change quantification and modelling methods;
- Evolving new regulations and implementing changes to the control environment;
- Government views on ESG and the impact to the legal framework;
- Unexpected changes in market conditions; and
- Changes of client and investor preferences.

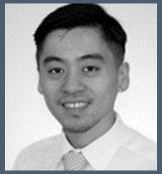
WHAT SHOULD INTERNAL AUDIT TEAMS THINK ABOUT?

- The ICAAP remains a key window through which the PRA evaluates the risk of the bank, and, therefore, a component of the risk management framework that IA should be addressing concretely in the audit plan.
- Considering how the bank is validating the extent and content of the ICAAP disclosures is the minimum that IA needs to be addressing. Increasingly, banks are having either external support in generating the ICAAP or external reviews of the ICAAP pre-submission. If senior management are not using sufficient and appropriate resources for the ICAAP, then IA needs to be raising the challenges. In our conformance with the CIIA's FS Code, we typically include ICAAP reviews in our audit plans for outsourced IA clients unless there are alternative means through which capital and liquidity risks can be appropriately addressed.
- IA's assurance work should include consideration of the climate/ESG aspects of the ICAAP against the wider strategies and disclosures of the bank for consistency and coherence.

07

MORTGAGE CHARTER

ALISON BARKER
Senior Adviser



KEVIN ZHANG
Manager

MORTGAGE CHARTER

The mortgage sector has been moving at pace with changes to interest rates. Alongside this, the Government and FCA have also been addressing the effects of the rises in interest rates on consumers in the mortgage market, especially during the current rises in cost of living. On 26 June 2023, Chancellor of the Exchequer, Jeremy Hunt, made a statement in the House of Commons on help for mortgage borrowers. The measures outlined in the 'Mortgage Charter' intend to offer comfort to those who are anxious about high interest rates and support for those who do get into difficulty.

In summary, the previous Tailored Support Guidance (TSG) has now been consolidated and is being introduced on a permanent basis into MCOB (CP23/13). It is broadly the same, applies to regulated mortgage contracts, and includes the requirements to consider the customers individual circumstances to come up with an appropriate options. It includes moving to simple interest. The FCA has also issued further guidance earlier in the year – again consistent with TSG. It is more outcomes and less process focused with a requirement to regularly assess consumer outcomes. To note, these changes apply to MCOB and CONC, therefore unsecured lending is also included in these measures.

The 'Big Six' banks: Lloyds, Barclays, HSBC, Nationwide, NatWest, Santander; have already signed up to the Mortgage Charter. Other signatories include TSB and a host of building societies, which together represent around 85% of the UK mortgage market.

According to figures from UK Finance, about 800,000 fixed rate mortgages will expire before the end of 2023 and a further 1.6 million due to end in 2024. As at June 2023, the average 2 and 5 year fixed rate mortgages were 5.79% and 5.63%, respectively (Moneyfacts). Those reverting to standard variable will see rates in excess of 6%. A sizeable monthly increase in mortgage repayment terms for borrowers coming off a 2% fixed rate.

The measures in the Mortgage Charter will provide short term relief for borrowers during this transitory period of high inflation and hawkish rate hikes. In essence, this allows additional options and flexibility, however it does not apply to Buy-to-Let (BTL) mortgages if these are not regulated mortgage contracts (the point is explicitly made in the GOVT text).

THE MORTGAGE CHARTER

The FCA has introduced new rules in MCOB to enable aspects of Charter. Signatories have agreed the following:

1. From 26 June 2023, a borrower will not be forced to leave their home without their consent unless in exceptional circumstances, in less than a year from their first missed payment.
2. With effect from 10 July 2023 customers approaching the end of a fixed rate deal will have the chance to lock in a deal up to six months ahead. They will also be able to manage their new deal and request a better like-for-like deal with their lender right up until their new term starts, if one is available.
3. A new deal between lenders, the FCA and the government permitting customers who are up to date with their payments to:

- Switch to interest-only (IO) payments for six months; or
- Extend their mortgage term to reduce their monthly payments and give customers the option to revert to their original term within 6 months by contacting their lender.

Key points to note:

- While the Mortgage Charter has not specified what "exceptional circumstances" are, the 12-month repossession protection is in line with the existing MCOB 13 requirement that lenders must not repossess the property unless all other reasonable attempts to resolve the position have failed.
- Lenders will still be expected to consider appropriate forbearance arrangements for borrowers in financial difficulty. The term extension or 6-month IO switch must be deemed suitable and appropriate for that customer's circumstances. Notwithstanding, if a customer insists on a course of action that the firm regards as harmful, they are not obliged to prevent it.
- Lenders must consider consumer duty objectives when devising new products. Allowing borrowers to lock in deals up to 6 months ahead of term expiry can undermine consumer remortgaging choices.
- Firms will need to make sure customers understand the features, costs, and benefits of the option they choose, before the change takes effect. This means personalised disclosures outlining the specific changes to the borrower's amounts due, including, where it is known, that the payment will change, the new payment and the date of the change in accordance with existing rules per MCOB 76.28R.

Ultimately, flexibility for mortgage holders can't be a bad thing. However, we must maintain some perspective:

- While it sounds impressive that lenders covering 85% of the mortgage market have signed up, being only applicable for owner occupied mortgage holders, this accounts for about 28% of the entire mortgage market. 36% of homes are owned outright and another 36% are rented properties (according to the Office for National Statistics).

MORTGAGE CHARTER

- The options offered in the charter are tailored short term support solutions which may suit some customers. Much like the deployment of Mortgage Payment Deferrals (MPDs) during COVID-19, the longer-term impacts of these contract variations are yet to be seen.
- For mortgage holders who are fundamentally struggling with repayments, the Charter does not solve the deeper issues of affordability. Lenders should ensure they are ready to provide appropriate support to borrowers in this position and address challenges with the Consumer Duty requirements in mind.
- Homeowners who bought as late as 2020 would still have seen capital gains in their properties, some in excess of 20%. There is opportunity for those struggling to cash in on those capital gains.

BTL MORTGAGES

BTL mortgages are not regulated mortgage contracts unless they are consumer BTLs, which means the property is let to a family member (i.e. bought by trustee or family member for relatives).

UK Finance has issued guidance on treatment of arrears which would be best practice to follow. For example, this covers dealing with the tenants of a defaulting BTL mortgagee. The FCA also published results of a thematic review last summer highlighting that treatment of SME customers by banks was poor and needed to be improved.

WHAT SHOULD INTERNAL AUDIT TEAMS THINK ABOUT?

For banks, building societies and mortgage customers, the Charter and revisions to MCOB enable greater flexibility to support customers through challenging times.

Banks and building societies should ensure that there are sufficient communications and capacity to deal with demand and help customers through the options available.

All these requirements will sit under the established framework of the Consumer Duty and vulnerable customer guidance, and, therefore, having MI to monitor customer outcomes and make adjustments as necessary will be critical. Internal audit teams should already have assurance activities in place, following implementation of Consumer Duty, to determine if the firm's processes are flexibly translating the Charter's aims into good outcomes for consumers.

Outcomes testing will be crucial to ensure that good outcomes for customers are materialising from the Charter's requirements. From our work with firms we have the following observations about testing for outcomes that Internal Audit teams should consider in their planning process:

- Most firms will have completed extensive work to make sure policies and procedures meet the standards in the TSG, including regular quality assurance reviews;
- Implementing the Consumer Duty, firms should be thinking about testing outcomes and mapping the customer journey;
- Firms should be going further in defining good outcomes as well as testing that policies and procedures are followed e.g. regular testing of consumer calls for example testing the questions customers are asked and the offers made to them;
- Testing how staff engage with customers, such as showing empathy and support to customers to illicit information and get the right outcome rather than starting conversations with 'how much can you pay';
- MI and data that shows patterns of customer payments or where customers may be at risk of falling into arrears;
- Testing outcomes around hand-offs to debt advice;
- Completing root cause analysis and feeding learning into training or policies and procedures, ensuring action taken is documented;
- Regularity of testing is likely to be a matter for each individual firm, but the testing should be regular enough to be useful and, thinking of the Consumer Duty, should consider events that may cause foreseeable harm – e.g. changes in interest rates or seasonal changes which see an increased burden on households.

From a credit risk perspective, monitoring risk exposure will be important. Outcomes monitoring, Board or Board Risk Committee reporting and record keeping will need to be updated by 1LOD and 2LOD teams, and assured by IA teams to appropriately mitigate risks.

08

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. We covered Credit Risk management in our November 2022 pack.	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. This subject is covered, above, in this edition.	The PRA will continue ongoing assessment of individual firms' capital and liquidity positions as well as how these September 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. We explored Risk Management in our March pack.	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. This subject is revisited, above, in this edition.	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 (MRM) remain a priority. We assessed developments in MRM within our June pack.	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. This subject is covered, above, in this edition.	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 person 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. Our monthly packs provide regular coverage on climate change financial risk developments - including this month (see above).	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. We have tracked DEI developments recently within our June pack.	
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. We have explored this subject in our April pack.	

FOR MORE INFORMATION:

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