INTERNAL AUDIT SUPPORT

BANKING & BUILDING SOCIETIES

April 2023

IDEAS | PEOPLE | TRUST

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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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.

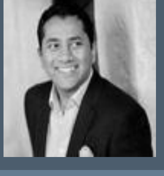
2023 REGULATORY PRIORITIES

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



SAM PATEL
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 Sam Patel.

1. What has been your career leading into BDO?

I qualified at Deloitte and stayed for 9 years. I got tired of delivering the same huge external audits on repeat. I felt like I wasn't learning anything new, so I took a breath and jumped into industry. I had a fantastic experience working in the finance function of a FTSE100 company. I was involved on the onboarding of two acquisitions, set up quarterly reporting and even constructed a cash flow forecast from scratch! I learned so much in a short space of time.

However, I was missing the variety of senior client interactions, meeting new people, going to different client sites so I hastily retreated back into practice to a top 10 firm who wanted me to join them as an internal audit Director. Being an auditor at heart, I took to it like a duck to water, and with an element of being in the right place at the right time, I was promoted to Partner within 6 months. That was in 2012.

When BDO merged with Moore Stephens to become the 5th biggest practice in the UK, I really took notice. I had to get a job here. I felt that I wasn't learning anything new where I was, and I wanted a new challenge. I got in touch with a member of the BDO executive, and after 10 months of various meetings and interviews was offered a role just after the COVID-19 pandemic started.

I started life at BDO in September 2020 and have never looked back! Whilst I am quickly coming up to three years, I am continually amazed by the quality of the people I work with, the leaders within my team and the wider firm. I love the fact that the firm is so diverse and, as a result, I continue to learn, develop and be inspired!

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

First and foremost, I lead a portfolio of outsourced and co-sourced internal audit engagements bringing in the relevant specialists, as required. I also lead the delivery of external quality assessments (EQAs) across financial services clients. This is something that I really enjoy doing and feel that clients really appreciate the added value and benchmarking that we bring when performing these reviews. Whilst I work alongside a fantastic group of four other FS internal audit partners, I work in a fabulous team with a lot of talented people who keep me on my toes! My final role is that I lead on innovation across our Advisory practice. This is something I'm very passionate about. I continue to challenge the team into looking for ways in which we can work smarter and more efficiently. Different ways of working to help the team and our clients succeed is something that's very important to me and a focus of the firm.

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

I have just completed the delivery of an EQA at a global financial services institution with one of the largest internal audit teams globally. As I mentioned, above, I find it extremely rewarding when clients appreciate the support we provide, and we brought valuable insight and added value that was well received.

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

The variety of the job and the people I work with. Whether I am at a client or in the office, I am surrounded by so many smart people who I love working with and learning from. They are also a super fun bunch! I also love the fact that every day is very different. You can go in expecting to get certain things done and come out of the day not having done any of them!

5. What drives you to do what you do?

I'm very lucky in that I really love this job. I love working with the team. Love helping clients. I feel like I am lucky to have found a job that plays to my strengths.

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

How trusted and respected you are as the "third line of defence" and senior leaders of the business world listening and valuing what you have to say.

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

Don't be afraid of shadows. People spend so much time worrying about things that might happen only to worry all over again if they do then happen. Don't waste your time worrying about the shadows.

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

Increased use of data analytics is the obvious one, but the potential of using AI I see as high on the list. Larger IA functions have more people and budget to experiment more in these areas and the things I have seen have been very impressive. I think there will also be an increased focus on skillsets and diversity of views. Exciting times ahead.

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

I'm mostly ferrying around my two sons when I am not at work, and I enjoy managing my eldest's Saturday football team. I have an annual cinema pass and love watching films.

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

Wine. A good playlist. Sunglasses.

03

ESG UPDATE

CLIMATE-RELATED RISKS AND REGULATORY CAPITAL FRAMEWORKS

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BANK OF ENGLAND REPORT ON CLIMATE-RELATED RISKS AND REGULATORY CAPITAL FRAMEWORKS

How should Internal Audit teams prepare for incoming regulations?

BACKGROUND

The focus on the prudential regulatory considerations related to climate change has remained high on the agenda in Q1 2023.

In March, the Bank of England (the "Bank") published its latest report on climate-related risks and the regulatory capital frameworks.

This follows the Bank's Climate Change Adaptation (CCAR) published in October 2021, which set out early thinking on climate change and the regulatory capital frameworks for banks and insurers.

It is important to note that at this stage, no policy changes are being proposed, but it sets out the Bank's current thinking and areas for further work which should be on the Internal Audit agenda as horizon risks.

It should also be noted that there is no proposed specific and prescribed requirements for Pillar 2A add-ons for climate-related risks, although the PRA has stated that it will continue to build its understanding of firms' evolving approaches to Pillar 2 capital add-ons through ongoing supervisory review and evaluation process and, based on that, make an assessment of whether any changes to Pillar 2 methodologies for these purposes are warranted.

Also, as noted in the Bank's CCAR, the Bank remains of the view that:

"regulatory capital is not the right tool to address the causes of climate change (greenhouse gas emissions), but should have a role in dealing with its consequences (financial risks)".

KEY FINDINGS IN THE LATEST REPORT

The key findings from this latest report were:

- Capability gaps (the inherent difficulties in identifying and measuring climate risks) and regime gaps (the challenges in capturing climate risks due to the design or use of methodologies in the capital frameworks) create uncertainty as to whether banks and insurers are sufficiently capitalised for future climate-related losses;
- As a short-term priority, the Bank will focus on ensuring banks and insurers make progress to address capability gaps to improve climate risk identification, measurement and management;
- Regulators and the Bank need to focus on the development of scenario analysis and stress testing frameworks given the unique nature and time-horizon of climate-related risks in order to inform capital requirements, with the expectation that firms make progress in this regard too;
- The Bank will continue to explore how climate risks can be calibrated within the timelines embedded in existing capital frameworks, which are deemed appropriate at present;
- The Bank will need to consider regime gaps related to the calibration of macroprudential tools and how well they consider climate-related risks, including the need for them to facilitate an orderly transition to net zero, which may result in action needing to be taken;
- Further research and greater public dialogue on the topic would be valuable, not least to consider some of the aforementioned challenges listed above.

BANK OF ENGLAND REPORT ON CLIMATE-RELATED RISKS AND REGULATORY CAPITAL FRAMEWORKS

How should Internal Audit teams prepare for incoming regulations?

WHAT SHOULD INTERNAL AUDIT TEAMS THINK ABOUT?

As a concluding remark in the report, the Bank stated:

"Substantial further work is needed and there remain many open questions, notably on potential regime gaps to capture systemic risks from climate change and unintended consequences. The Bank will continue to address these questions as part of its supervision and policymaking".

Therefore, this is a strong indication that further regulatory developments should be expected in relation to climate change. With this in mind, Internal Audit should now take the opportunity to implement:

- **Training:** Since the regulator's minimum requirements, stated in PRA SS3/19, went live in 2021 feedback from the sector has consistently centred on the need to upskill IA team members to match pace with regulatory developments in this area. IA should promptly address the team's critical training requirements for climate change financial risk assurance work. The CIIA has developed a range of new technical guidance papers and has recently updated its "Climate change and environmental impact" paper to incorporate several key areas of focus for IA teams as regulations develop;
- **Information flows:** IA should also facilitate greater co-operation with the business functions, Risk and Compliance teams so that climate change regulatory developments and guidance information is consolidated centrally for easy and reliable access by the firm's personnel involved in managing climate change risk, including IA team members. Per the Bank's statement above, steady waves of regulatory consultations, statements, speeches and guidance papers will soon be published and its critical that the flow of key information to the IA team, and senior management, is relevant, timely and accurately interpreted for effective decision making;
- **Regulatory map for your assurance map:** As the recent Regulatory Initiatives Grid (February 2023) shows, several other climate change related regulatory developments will be in flight this year. A helpful approach could be to use the Grid as the basis for a Gantt chart or heatmap to map key 2023 regulatory events and overlay that with your sector-specific and firm-specific ESG requirements to be able to 'join up the dots' and target review areas with better timed assurance, thereby improving audit efficiency and effectiveness.

04

EXTERNAL QUALITY ASSESSMENT
INSIGHTS FROM OUR GLOBAL MARKET EXPERIENCE

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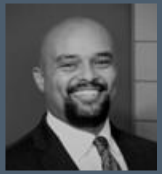

BRUK WOLDEGABREIL
Associate Director

EXTERNAL QUALITY ASSESSMENT

Insights from our global market experience

THE IMPORTANCE OF QUALITY ASSESSMENTS

“Quality” could be defined as the degree to which a product or process meets its expectations.

With that said, it should be no surprise that the IIA places substantial emphasis on the importance of a well-established quality assurance and improvement programme (QAIP), periodic self-assessments, and an external assessment at least every five years to ensure that the Internal Audit (IA) function is operating to a sufficient level of quality.

The reported outputs from the QAIP and external assessment are crucial for the Head of Internal Audit (HoIA) to demonstrate the quality of the IA activity in meeting the expectations of the charter and the degree to which the firm’s Audit Committee and Board can place reliance on the function’s assurance activities.

However, the 2022 CIIA Benchmarking Report revealed that 34% of IA functions that responded to their 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 a facilitated self-assessment supported by an advisor, could help unearth critical issues affecting the efficiency and effectiveness of the IA function, or indeed the wider environment in which the function operates.

In this article, as part of our series exploring Quality, we briefly explore the key steps in an EQA process and the considerations that internal audit teams should have front of mind before, during and after an external assessment to maximise the review’s outputs.

WHAT WILL THE EQA EXAMINE

An external assessment, whether conducted by the IIA or a qualified, independent, assessor such as BDO will not follow a generic checklist. While the IIA standards, Code of Ethics and CIIA FS Code requirements will form the basis for an external assessment, it is critical that the assessment covers whether the IA function is achieving its stated purpose and remit, as well as its standing in the firm, i.e., what is the firm’s perception of the IA function? Is it considered useful, competent, and reliable?

Additionally, the assessment will consider:

- **Resources, skills and competencies available in the function:** including its resourcing strategy to support technical and specialist reviews (e.g., co-source and advisory resources available on demand);
- **Internal audit methodology, tools and processes:** this would include policies and procedures, templates / approved formats, approach to sampling, data analytics, and use of audit workpaper software;
- **Performance:** does the IA team ‘make a difference’ or is it ‘going through the motions’? Is the governance within the IA team effective and are operations sufficiently supervised to achieve quality expectations? Are the KPIs and KRIs set by the HoIA supporting an efficient function that maximises the limited (almost always stretched) budget to achieve the annual plan? Is the function distracted by getting involved in first- and second-line work?
- **Reporting results (outputs):** the quality of submissions to the AC and wider Board needs to be value-adding strategic reports, focused on the big picture of how the firm’s risk and control framework is holding up against the fast evolving regulatory and economic landscape. Does the reporting provide the committee with everything it needs to know? Is it succinct or voluminous? The Audit Committee will not need to go into the finer details of how many items were sampled etc.

BEFORE THE EQA

Preparation for the external assessment will need the HoIA to engage with the AC and wider executive management to secure the necessary budget and discuss scope for a meaningful assessment of the function. Keep in mind that, while the AC Chair should oversee and approve the appointment process for the independent assessor (Section G, CIIA FS Code), it’s incumbent on the HoIA to drive this process every five years (if not requested by the Chair of AC) as set out in AS 1312 (“External Assessments”).

All being successful, a tender process should commence to consider the qualified and independent assessors available to carry out the assessment. The HoIA should encourage Board oversight in the appointment of assessor and oversight of the assessment process to mitigate any perceived or potential conflicts of interest.

EXTERNAL QUALITY ASSESSMENT

Insights from our global market experience

DURING THE EQA

Following appointment of an assessor, the EQA team will engage with the IA function for:

- Review of prior EQA outputs (if any available);
- Discussion with the IA team to ensure coverage across seniority grades, one-on-one interviews with a selection of IA staff, excluding the management team, to get a tangible sense of what the IA team thinks about itself, its value to the firm and how the firm perceives the function;
- Sending out a survey to the firm's senior management to build a picture of how the IA function is perceived and whether IA adds value to the business;
- Requesting key documents, e.g., the function's policies and procedures;
- Scheduling interviews, stakeholder meetings and progress update meetings. For larger IA functions, especially if assessing across multiple jurisdictions, this may require a designated point of contact to facilitate introductions and oversee logistical arrangements to be as efficient as possible to support the assessment team;
- Drawing a sample of audit files to assess if engagements have followed established processes, appropriate scoping considerations, and key risks have been sufficiently assessed.

An assessment of the function's conformance with the IIA standards, Code of Ethics and CIIA Financial Services Code is essential throughout the review, as well as any other applicable internal auditing standards, codes and professional guidance for all the jurisdictions that the IA function provides assurance.

We consider this aspect through a case study (further below) following our recent EQA engagement for a globally significant financial services institution.

AFTER THE EQA

The assessment will eventually conclude on whether the IA function is Generally Conforming, Partially Confirming, or Not Conforming to the standards, Code of Ethics and FS Code. This would include any recommended remedial actions for identified vulnerabilities.

But an effective EQA report should also identify any relevant insights, observations, benchmarking and thoughts from the assessment team to help the function improve its effectiveness and, overall, add value to the HoIA. As with any report following assessment, there would be a close out meeting to include the HoIA, AC Chair and senior management team to incorporate feedback into the drafting of the final report.

The IA function would then be able to present the final EQA report to the Audit Committee. Monitoring of remedial actions could then be baked into the QAIP and progress reported by the HoIA to the Board and senior management as part of their conformance to AS 1320 ("Reporting on the Quality Assurance and Improvement Programme").

EXTERNAL QUALITY ASSESSMENT

Insights from our global market experience

CASE STUDY - EQA FOR A GLOBAL FINANCIAL SERVICES INSTITUTION

We recently completed an EQA for a globally significant FS institution by assembling an international team of audit experts from across Europe, UK and the US to provide our client with the specific skills, expertise and insights that they needed from the review. In addition to reviewing the IA function against domestic, European and Global Internal Audit standards (including the CIIA Financial Services Code), the client also asked us to review the maturity of its data analytics strategy and risk culture within the IA department.

Our review considered the global assurance work undertaken by the IA activity, as well as the country specific engagements and reporting that the team does for the cross-border business activities including major operations in some specific global countries.

We were able to work collaboratively with the client to deliver on the necessary timelines they had, given the dates on which Audit Committees to present the EQA were to take place and when senior stakeholders were best available.

The key driver for this successful EQA - a clear work programme, well-structured and well-organised around the overlapping reviews against the different applicable auditing standards, thereby reducing duplication and working effectively within the budget.

Our presentation of the report results to the Group CEO, Chair of the Audit Committee, Internal Audit ExCo and senior board executives have been very positively received, specifically noting that the insights and observations that we made were valuable and ‘confirmation of why we chose to go with BDO in the first place’.

Following on from the work that was done in the EQA, we are exploring with the client how we can help them to get more efficiency and effectiveness in the delivery of their overall audit plan and looking to improve overall performance of their assurance programme.

05

INTERNAL AUDIT REVIEWS REQUESTED BY THE REGULATOR

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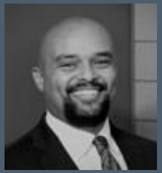
Director



BRUK WOLDEGABREIL
Associate Director

CHRISTIAN JONES
Senior Manager

HOW TO RESPOND TO AND MANAGE INTERNAL AUDIT REVIEWS REQUESTED BY THE REGULATOR

Regulators may request firms to complete internal audit reviews with a prescribed scope to support a broader thematic review. Such thematic reviews are typically focused on an area of recent regulatory change or growing concern and are to be led by the firm's Internal Audit function.

The various reports are provided to the regulator who then sets out findings and actions that firms should take. For example, during 2022, the Financial Conduct Authority reported on the findings from the SME collections and recoveries review.

This article explores how to manage and respond to an internal audit review to be performed at the request of the regulator and how to deliver these in conjunction with internal audit review activity aligned to key strategic risks relevant to your firm.

YOU GET A LETTER FROM THE REGULATOR, NOW WHAT?

If your firm is selected to take part in a thematic review, you will receive a letter detailing the review's requirements. This could include:

- Details of the required scope;
- Any relevant scope exclusions;
- Administrative details, such as follow up expectations, or amendments to scope; and
- Submission requirements.

Typically, the first step is to ensure appropriate communication of the thematic review within your firm. Typically, this involves the Head of Internal Audit (HoIA), Chair of the Audit Committee and CEO, and should ensure the Board and Senior Management are informed of the regulatory request.

The HoIA will need to also assess the potential impact on the Internal Audit Plan. In our experience, many internal audit functions are not resourced with sufficient contingency in resource availability to be able to deliver regulatory driven reviews without adjustment to the priorities or sequence of assurance activity.

However, before pencils are sharpened for a new engagement to be added to the audit plan, a helpful question to ask is "have we been here before?".

HOW TO RESPOND TO AND MANAGE INTERNAL AUDIT REVIEWS REQUESTED BY THE REGULATOR

MAXIMISING RECENT AND RELEVANT ASSURANCE WORK

If your firm has recently completed a review with a similar scope to that requested by the regulator, you should consider proactively contacting your Supervisory Team to discuss the report's scope, criteria, and its conclusions. The regulator may assess that the completed assurance work could address some, or all, of the thematic review requirements against an agreeable criteria, thereby negating the need for the firm expending further internal audit work.

The internal audit team should consider when the previous review activity took place, along with progress towards resolution and embedding of any actions or recommendations.

Key considerations:

- Have we completed any similar review work recently?
- Was the purpose of the firm's recent review, and its criteria, relevant to the regulator's aim of gathering sectoral assurance?
- Would the firm's progress against the review's recommendations and remedial actions provide the regulator with a perspective that the firm is managing risk?

REVIEWING THE ANNUAL PLAN AND IA RESOURCING STRATEGY

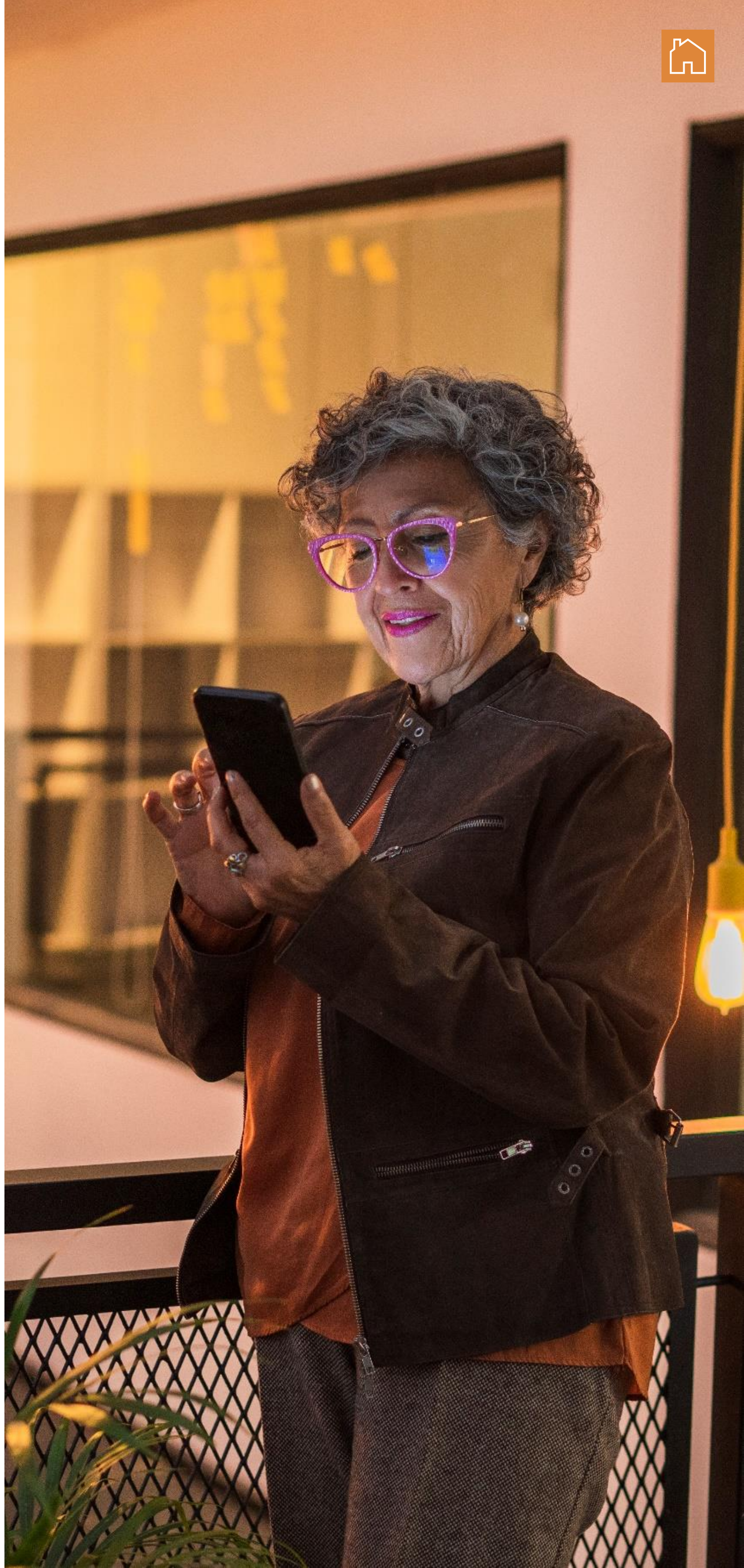
Assuming that the review requested by the regulator is to be completed, the HoIA will now need to review the annual audit plan and is likely to seek approval from the Audit Committee for changes to the plan. The HoIA may also have to promptly trigger aspects of their resourcing strategy for the regulatory review to have sufficient and appropriate resources – a subject covered in detail within our March report.

Given the nature of the request and the requirement for multiple firms to complete the review alongside other business priorities, the regulator will generally provide what may appear to be a generous amount of time for completion. This time is easily spent and, from our market experience, not always used efficiently.

The first step should be to review the annual audit plan in the context of the request. The goal should be to determine what resource is required to complete the review to a high standard and what changes may be required to the plan to enable this. If the addition of the review leads to a significant risk exposure or de-prioritisation of work in high-risk areas, then other options for delivery or support may be appropriate:

Key considerations:

- What technical or specialist skills are required to deliver this thematic review to the right standard?
- If the IA function has a co-source partner, what is the optimum nature of the support that you would like to deliver the review and does the co-source partner have the right practitioners available at the right times to deliver this?
- Aside from the thematic review's impact on the audit plan, what knock-on impact will it have for the firm's assurance map, i.e., will the firm's other assurance providers, e.g., Compliance, have to adapt their planned activities?



HOW TO RESPOND TO AND MANAGE INTERNAL AUDIT REVIEWS REQUESTED BY THE REGULATOR

PLAN EARLY AND PROPERLY

Just because you have plenty of time to deliver the review doesn't mean you should delay; the engagement planning process should start as early as is practical. An initial step should be to identify the review's key stakeholders for a scoping meeting, to develop a deeper understanding of the audit area and secure the support of the area's management and staff. The IA team should share a copy of the scope points with appropriate colleagues to support planning discussions and maintain visibility of the review's requirements throughout the engagement.

When drafting the work programme, ensure there is a "golden thread" between the regulator's letter, the review's scope and the testing procedures designed to achieve the thematic review's objectives. Early and efficient planning for the review will demonstrate to the regulator the prudent and professional approach the firm's IA team, and ultimately its management, adopts to fulfil the regulatory request. Keep front of mind that engagement documentation is a critical component of internal auditing (PS 2330) and may be requested by the regulator alongside the final report to help verify the review's methodology and route to the reported findings. Given the nature of the review, additional time should be built in to allow for review and approval at an executive level.

In a recent example from our delivery work, a client had developed a delivery plan based on routine internal audit procedures without first considering the enhanced scrutiny or approval requirements necessary for an internal audit report that would be shared with the regulator. We were able to support in developing a delivery plan that factored in the review of findings and recommendations at relevant committees, including Audit Committee, and Board. The client followed the revised plan and was eventually able to meet the delivery deadline set by the regulator. Key considerations:

- What are the delivery deadlines for review planning, fieldwork and reporting?
- Who are the key stakeholders for the review and what is their availability during the review timetable?
- What relevant processes and technology will the IA team have to get up to speed on promptly for planning to provide sufficient coverage of risks?
- Given the exposure (to the regulator), and potential complexity, of the review is there is experienced supervision in place within the IA team to ensure that golden thread between the regulator's letter, planning, work programme and reporting?
- Are there any known or previous issues to be considered within the scope of the review, or have there been recent changes in the control environment? If so, these considerations need to be factored into the timing.

In some cases, completing the review early will be of benefit so that any control improvements are known and understood as soon as possible. However, there will also be instances when other factors exist that makes it necessary to perform the review closer to the deadline.

ONGOING MONITORING AND FEEDBACK

The impact of the collective findings of the thematic review can be significant. With that in mind, it is vital that the IA function maintains effective reporting to the Audit Committee and senior management on the review's observations as the audit work progresses. As with all good audit work, there should be no surprises by the time of reporting.

Where feasible, leverage IA resources unconnected to the review, including second-line oversight if appropriate within independence requirements, to sense check findings and proposed solutions. It is important to have as much objective challenge placed on the review's outputs internally before it is opened up to regulatory scrutiny.

Progress and outcomes of these reviews are often a hot topic at industry forums arranged by trade associations, e.g., UK Finance, Building Society's Association, etc., or forums for specific professional disciplines. It would be good practice to make use of these discussion opportunities to informally benchmark your firm's review findings at a high level (ideally, under the Chatham House rule) to ensure that the firm has broad consistency with a consensus of peers.

Key considerations:

- Has the IA function implemented an effective reporting function to the AC and management to monitor progress and circulate observations on a timely basis?
- Are we using available opportunities to appropriately benchmark findings and proposed responses with peers?

WHAT SHOULD INTERNAL AUDIT TEAMS THINK ABOUT?

Should your firm be asked to participate in a thematic review, the key to delivery is appropriate preparation and planning throughout the review. This includes making sure that there is a clear understanding of the scope, an appropriately resourced team with the right knowledge, skills and experience to deliver the review and a robust internal audit delivery approach.

Careful planning is also needed to ensure that meeting the demands associated with a regulatory driven review does not compromise the delivery of assurance to other areas of high risk on the Internal Audit Plan.

06

BASEL 3.1 AND THE STRONG & SIMPLE REGIME: WHAT DOES IT MEAN FOR BANKS AND BUILDING SOCIETIES?

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BASEL 3.1 AND THE STRONG & SIMPLE REGIME

What does it mean for banks and building societies?

Basel 3.1 (PRA Consultation Paper 16/22) is the final jigsaw in the Basel 3 package of reforms which sets out the amounts of capital and liquidity firms are required to hold. Basel 3 was the regulators' response to the 2008 global financial crisis and it has been in place since January 2014. Basel 3.1 is expected to go live on 1 January 2025.

The Basel 3.1 proposals have some significant changes to the way firms calculate their Pillar 1 capital requirements, i.e., risk-weighted assets (RWAs). Basel 3.1 is also the first major regulatory change post-Brexit and this provides the Regulator with the opportunity to undertake a wholesale review of its Rulebook and to apply a more proportionate approach, referred to as the "Strong & Simple Regime".

So, what does this mean for UK Banks and Building Societies? The answer depends on the size of firm and the types of regulatory permissions held. The main changes and considerations in Basel 3.1 are set out below:

Proportionality under the Strong & Simple Regime: The consultation provides smaller firms that meet the 'simple-regime' criteria to opt-out of the Basel 3.1/UK CRR requirements and opt-in to the new simplified regime. The criteria for this regime is driven by balance sheet size (<£20bn), complexity (limited trading book activities/FX exposures) and location of the credit exposures (at least 85% in the UK).

This approach adopted by the Regulator seeks to establish a more proportionate application of prudential regulations, including simplified requirements for own funds and liquidity. The PRA has, so far, published the Pillar 3 and liquidity requirements including less onerous liquidity requirements, removal of liquidity Pillar 2 requirements, simplification of the ILAAP and removal of the Pillar 3 disclosure for non-listed firms. The capital requirements under the simplified regime are expected to be published later in 2023.

Changes to Risk Weighted Assets: New asset classes and risk weights are being introduced under the standardised approach to reflect a more risk-based approach. The main changes can be found in the residential property lending segment where the current 35% risk weight is being replaced by multiple risk weights based on loan to value bands and whether the residential mortgages are dependent on cash flows from the property.

The typical owner-occupied residential mortgage will get a risk weight based on the loan-splitting approach where amounts up to 55% of LTV will get a 20% risk weight and the remaining part will be risk-weighted in line with the counterparty type. For residential mortgages this will be 75%.

The loan-to-value could soon be based on the value at origination and not the current market value. This is likely to have a significant impact on some firms, although this impact is partially offset by updating the original value when the customer remortgages.

Several new asset classes are also being proposed. Most notably the introduction of a new asset class for corporate loans with the option to risk weigh at either 65% or 135%.

Introduction of a capital floor for IRB firms: Firms under the IRB approach will have a capital floor imposed at 72.5% of the equivalent calculation under the standardised approach. This is likely to lead to a significant increase in the RWAs for some portfolios that benefit from a low risk-weighted percentage under the IRB approach.

The consultation also suggests further restrictions to the IRB permissions, including setting a PD floor of 0.05% and imposing restrictions on the IRB approach on certain asset classes.

BASEL 3.1 AND THE STRONG & SIMPLE REGIME

What does it mean for banks and building societies?

WHAT SHOULD INTERNAL AUDIT TEAMS THINK ABOUT?

It is critical that IA teams review the Basel 3.1 proposals carefully, as this is likely to have a significant impact for most firms and the overall UK financial services industry.

Assurance planning should consider the following activities:

- **Impact assessment:** Calculate the impact of Basel 3.1 on capital ratios (including Pillar 2A and Pillar 2B). This should include a detailed RWA impact assessment covering all asset classes and the impact to the overall portfolio. Smaller firms should also assess whether it is beneficial to opt-in to the Strong & Simple Regime.
- **Business Model Review:** Following the outcome of the impact assessment, IA teams should review risk appetite and pricing to ensure that portfolios/exposures that change under Basel 3.1 are adequately priced and managed from a risk perspective.
- **Review of systems and process:** IA teams need to be prepared for systems and process changes driven by the new rules. This will include IT changes, documentation updates and new business processes. This is likely to be a significant change management activity for a number of firms and early review planning should consider resources required to address complex change reviews.

FOR MORE INFORMATION:

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