INTERNAL AUDIT SUPPORT

INVESTMENT & WEALTH MANAGEMENT UPDATE

December 2022





BDO FS INTERNAL AUDIT CONTACT POINTS

We hope our insights during 2022 have supported your Internal Audit activities, and we look forward to our next edition, to be published in February 2023, where we will explore the coming year's key risks and regulatory developments with which to appropriately evolve annual plans.

Until then, from all of us at BDO, we wish you a very enjoyable holiday season and a happy New Year!

BDO's Investment and Wealth Management Update summarises the key regulatory developments and emerging business risks relevant for all designated investment firms and wealth managers.

Our FS Advisory Services team are working with more than 60 investment and wealth management firms, including platform providers and administrators, 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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HEADS OF INTERNAL AUDIT: DIVERSITY & INCLUSION (D&I)



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► Financial Services Heads of Internal Audit Roundtable - D&I Audits

On 7 December, BDO's Financial Services Advisory practice hosted a Heads of Internal Audit roundtable for audit leaders drawn from banking, asset management, insurance and payments sectors, as well as the CIIA, to discuss the insights they have gained from recent D&I audits, common challenges faced and good practices developed from reviews to help fellow auditors better support their firms' D&I agenda.

While some firms may aspire to a target model for their D&I, the discussion found that most firms sit somewhere on a maturity scale between "initial" development, e.g. establishing D&I objectives, basic data and KPIs, up to "optimising" levels of maturity in which D&I has been holistically threaded into every business function.

Whatever the firm's current D&I maturity may be, the discussion noted common benefits from progressing a D&I review:

- Improving the firm's market competitiveness and profitability: it was felt that without first addressing the values, behaviours and overall D&I culture of a business, the firm will not be able to appropriately consider the needs of its increasingly diverse client base. The firm's senior management could be trapped in an echo chamber of its deep-rooted beliefs, unable to adapt and maximise new opportunities. This issue becomes even more acute when we consider the incoming Consumer Duty requirements, to be implemented by July 2023, in which staff will have to proactively empathise with every aspect of the client's journey to ensure they have good outcomes. Research has shown (McKinsey, May 2020) that firms in the top quartile of gender diversity were 25% more likely to experience above-average profitability than peer companies in the bottom quartile.
- Mitigating the growing costs from recruitment and a lack of staff wellbeing: the roundtable identified a poorly managed D&I strategy as one of the common root causes behind high staff turnover, especially in junior staff, and stress leave related costs. Recruitment costs were also climbing from successful candidates rejecting job offers on the basis of negative feedback about an employer's progress against D&I objectives, e.g. public reviews left on Glassdoor and other job sites.
- D&I as an opportunity for IA to demonstrate value-add: after Cyber Risk, the second most critical risk reported in the CIIA's Risk in Focus 2023 survey was Human Capital, Diversity and Talent Management. In terms of addressing a firm's highest risk areas, D&I is an auditable area in which Internal Audit can proactively demonstrate its organisational value to improving a firm's governance and culture. The roundtable roundly agreed that a D&I review is not a "nice to have"; if IA teams are not actively facilitating its leadership, then they risk becoming obsolete as future leaders will put this issue at the core of governance processes.

▶ What were the "lessons learned" from recent D&I reviews?

- Scepticism and defensiveness: D&I audits are relatively new and broach a sensitive topic the diverse nature of our individual identities and the extent to which firms are inclusive of our true selves. Unsurprisingly, recent D&I audit experiences discussed at the roundtable share a common thread of defensive questions from auditees, for example: "we are already diverse, why audit this area?"; "how can you rate this subject, its too woolly", etc. A helpful approach for early stages of D&I maturity has been to focus the scope on talent management to help improve recruitment and succession planning. Future reviews, or follow on work from an initial assessment, can then focus on gathering richer data on higher-risk areas to progress maturity.
- Data: Without sufficient data, its near impossible to appropriately manage, and thereby develop, D&I maturity. A common example was the lack of sufficient data regarding ethnicity of the staff population; a good practice noted was to seek ethnicity data on a volunteered basis when colleagues opt for their corporate benefits package a single survey question ahead of benefit choices resulted in one firm improving its stock of ethnicity date from 60% to 70% coverage of total staff. Additionally, gathering colleagues from different backgrounds to help consider metrics and values around inclusion can help mitigate the risk of "group-think" from the established committees and working groups of senior management personnel.
- Budget for external expertise: most Heads of Internal Audit that have completed D&I audits have noted the value that a D&I consultant can bring to an IA activity. D&I consultants have proved helpful to break down barriers and keep communications, especially in RCSAs and facilitated workshops, clear and effective. External experts can also inspire IA team members to proactively assess gaps in the maturity model that staff members can fill, e.g. a champion role to help facilitate D&I initiatives.
- Unconventional format: D&I audits can typically appear as unconventional, for example: most of the scope areas may not have a process or a control; the firm's strategy for its D&I maturity is unlikely to sit in one document, rather straddle a number of sources of information, firm publications and reports.
- Capitalising on "quick wins": while D&I maturity is part of a longer-term strategy, landing tangible benefits quickly supports bigger assessments. A good example was from a firm testing its talent management processes the findings showed that less than 10% of recruitment managers completed mandatory D&I training before conducting recruitment interviews and most interviews did not have interview notes, therefore unable to evidence decisions were within the firm's D&I policy. Findings like these can be used to promptly improve controls, demonstrate value-add and build the case for transformational change through larger assurance and consulting projects.

HEADS OF INTERNAL AUDIT: DIVERSITY & INCLUSION

What should Internal Audit teams be thinking about?

While its improbable to have an exhaustive list of all relevant considerations for an internal audit of D&I, given each firm's D&I maturity and strategic journey will differ, the roundtable discussion did identify a number of common good practices that have supported meaningful reviews, including:

- Tone from the top: it is essential to have senior management making it clear that D&I is a central part of the firm's strategy and fully supportive of developing the firm's D&I maturity. Examples of successful D&I reviews have included the CEO, or Chairperson, taking on the role as the D&I lead for the firm so that the subject is kept uppermost on the corporate agenda. This is most poignant for firms at the early stages of their D&I development in addressing any scepticism from within the executive, e.g. questions over the shareholder value from pursuing a D&I agenda amidst competing priorities. While this may appear to be an obvious consideration, this is likely the most challenging as it is a sensitive topic and, very likely, a challenge for senior management to be "comfortable with the uncomfortable" discussions that lay ahead.
- Resources: successful D&I reviews have generally included colleagues that have a
 genuine curiosity on the topic, possess high emotional intelligence, and practitioners
 who want to stretch their auditing soft skills, e.g. those that have a good track
 record in leading Governance reviews. Moreover, the mindset for an auditor
 delivering a D&I review should be closer to facilitative / supportive of developing
 D&I maturity within the business, rather than an investigative approach, given that
 the regulatory expectations and industry benchmarks are still evolving.
- Consult for an appropriate Maturity Model: engagement planning and preliminary
 risk assessment should involve sufficient consultation with qualified advisors to land
 on an appropriate maturity model as the criteria for a meaningful review. Qualified
 advisors could also help the firm maximise the audit by sharing the good practices
 they have noted in peer firms that have successfully delivered D&I reviews. The two
 critical steps at the planning phase would be:
 - I. to gain agreement with the D&I lead / senior management as to what "correct state" the firm aspires to, along with a sensible trajectory to land there, so that the assessment incorporates the firm's strategy and D&I objectives.
 - II. produce a view from the Board's expectations of "what good looks like", proportionate to the size and complexity of the firm. Realistic expectations, and support from external experts, helps put in place the preparations for an effective audit

- Regulatory expectations: the <u>FCA has recently published its multi-firm review of how firms are designing and embedding D&I strategies</u>. The regulator's findings on these strategies, and its overview of initiatives to improve diversity and inclusion, should be incorporated into the engagement planning process.
- Independence and the benefit of external expertise: audit leaders should consider the possibility that the IA activity itself may have already become absorbed into the firm's culture and, effectively, part of the issue it is trying to independently and objectively review, i.e., the internal audit team may not be sufficiently independent enough to effectively perform a D&I audit. The IA team could seek an external expert to provide an initial assessment of the firm, as well as the IA team, to ensure independence and establish a "current state" benchmark from which to map the firm's D&I maturity plan of action.
- CIIA technical guidance: the <u>Chartered Institute of Internal Auditors</u> does provide a
 range of technical guidance papers to support D&I reviews, including guidance on
 Board Diversity, Auditing Culture, as well as research reports that provide current
 insights from D&I reviews.

WIND-DOWN PLANNING



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Wind-down planning

- Being prepared for an orderly exit in case of a strategic failure or irreparable
 financial difficulties is extremely important in the financial sector, and a regulatory
 requirement. Wind-down planning is essential for all investment firms to understand
 and set out in writing how the firm can close down its business operations in an
 orderly fashion, with minimum impact on stakeholders, clients and counterparties
 and even the wider market. The potential for financial harm in failure becomes
 significant if a firm's wind-down is disorderly.
- More broadly, wind-down planning is expected to be undertaken by all firms in line
 with the structure recommended by the FCA in the WDPG sourcebook. Firms should
 follow the FCA's finalised guidelines in FG20/1 explains that one of the roles of
 adequate resources is to enable an orderly wind-down and the feedback from the
 thematic review TR22/1 as well as the recommendations in additional papers
 published by the FCA.

► Regulatory requirements

- Investment firms and asset managers that are in scope of the Investment Firms
 Prudential Regime (IFPR) will know by now how much importance the FCA has
 attributed to wind-down planning within the new prudential framework. A winddown plan is required under the MIFIDPRU rules.
- A firm must produce a reasonable estimate of the maximum amount of liquid assets
 that the firm would require to fund its ongoing business operations over the next 12
 months and also ensure that the firm could be wound down in an orderly manner.
 The calculation of wind-down costs is essential to meet the Overall Financial
 Adequacy Rule (OFAR) and affects both the own funds and the applicable liquidity
 requirements.
- Liquidity resources in wind-down become more prominent in the IFPR, as firms must maintain a minimum amount of liquid assets and determine whether additional resources may be required to commence an orderly wind-down process.
- Wind-down plans must include:
 - Assumptions for a solvent and insolvent scenario;
 - Operational analysis with step by step actions and timeframe;
 - Impact assessment of the harm caused to clients, counterparties and employees;
 - Resource assessment identifying required human and financial resources;
 - Communications plan.

Expectations

- A good wind-down plan must be comprehensive, credible and operable. Wind-down
 planning must include considerations of the risks which could cause wind-down, the
 harms that could flow from those risks and the resources required to do so in an
 orderly fashion.
- In their <u>recent thematic review</u>, the FCA confirmed that wind-down planning must be designed according to their guidance and standards, be risk-based, focus on cashflow management and consider group-wide implications.
- Firms with complex structures or within groups with multiple regulated entities should have sufficient governance arrangements and risk management controls. Firms should consider risks arising from the potential impact of group exposures such as operational dependencies, debt guarantees or group level pension liabilities.

► Good practice - what IA teams should expect within the business

- · Clear identification and regular reviews of the risks inherent in their business models;
- Strong consideration of the harms which could flow from those risks;
- Stress testing and reverse stress testing, embedded in the risk management framework, providing a broader view of the likelihood of risks crystallising;
- Detailed and well thought-out cashflow projections, including cash inflows and outflows, realisable assets and assumptions for wind-down;
- Strong risk management framework with risk metrics and forward-looking management information;
- Regular reviews of wind-down plans and the modelling of the minimum liquidity required to ensure orderly wind-down (annually or upon material changes).

▶ Poor practice - what IA team should be vigilant to within reviews

- Inconsistent or incoherent reporting of risks at different levels of the firm/group;
- · Failure to use the risk assessment to inform stress testing or wind-down scenarios;
- · Limited granularity in firms' cashflow modelling;
- Wind-down plan not sufficiently reliable or operable in practice.

WIND-DOWN PLANNING

► Key aspects of the wind-down requirements in MIFIDPRU

- The requirements apply to all investment firms, whether an SNI (small and non-interconnected investment firm) or non-SNI.
- Overall Financial Adequacy Rule (OFAR) includes being able to demonstrate that a firm holds sufficient resources to wind-down in an orderly fashion.
- Basic Liquid Asset Requirement (BLAR) sets the minimum amount of liquid assets at 1/3 of a firm's fixed overheads requirement.
- Own Funds Threshold Requirement (OFTR) and Liquid Assets Threshold Requirement (LATR) require a component derived from wind-down costs.
- ICARA Internal capital Adequacy and Risk Assessment must include wind-down planning.

► Liquidity and wind-down

- All firms are subject to the overarching liquidity requirement to meet liabilities as they fall due at all times. In addition firms are required to hold liquid assets that are sufficient to commence an orderly wind-down.
- The LATR calculation includes an assessment of the cost of the initial stages of a wind-down process, to determine whether the BLAR amount is sufficient or instead additional liquid assets may be required.
- The LATR must be presented in a quarterly breakdown over 12 months and assess the highest amount of liquid assets that is required in each quarter.
- The BLAR component must always be met with core liquid assets only.
- To quantify liquidity requirements, firms must maintain a complete and granular cashflow analysis. Firms are expected to analyse Business-as-Usual and wind-down inflows and outflows over a hypothetical implementation period to identify cash mismatches, potential gaps and the availability of any realisable assets.
- Liquidity risk can be greater in groups due to the impact of intra-group connectivity and financial dependencies. A group/parent failure scenario must be assessed in a wind-down plan to consider a firm's reliance on group liquidity.
- Setting early warning indicators and wind-down triggers allows sufficient time to seek contingency funding or take a wind-down decision before insolvency.

► Implementation challenges

- Wind-down planning is by default a theoretical exercise that requires well thoughtout assumptions, a solid risk management framework and then an effort of developing reliable cashflow projections and operational analysis.
- Key areas of challenge include:
 - Developing a wind-down plan in line with the WDPG guidelines;
 - Estimating both initial costs and total costs of an orderly wind-down;
 - Considering all long term contractual obligations and exceptional costs;
 - Ensuring that the plan is 'operable';
 - Applying the outcomes of the financial analysis to the OFTR and LATR;
 - Assessing group implications and liquidity requirements;
 - · Developing an insolvent wind-down scenario.

What should Internal Audit teams be thinking about?

- Review the design of wind-down plans to ensure compliance with WDPG, the FG20/1 guidelines and the recommendations in TR22/1;
- · Consider reviewing the operational effectiveness of the wind-down plan;
- Assess and challenge the methodology adopted in the calculation of wind-down costs and the impact on OFTR and LATR;
- Consider the liquidity risk assessment process and assess the soundness of liquidity resources calculations, stress testing and BLAR and LATR calculations;
- Review the impact assessment, operational analysis and timeline to ensure the winddown process can be completed in an orderly fashion;
- Review the quality and accuracy of the cashflow analysis and underlying data;
- Assess and challenge the solo and group-wide considerations made by investment firms that operate within a group.

ECONOMIC CRIME UPDATE



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European Banking Authority ('EBA') Guidelines on the use of Remote Customer Onboarding Solutions

- In September 2020, the <u>European Commission published it Digital Finance Strategy</u>, setting out a strategic objective to embrace digital finance for consumers and businesses.
- The EBA has followed up with <u>guidelines on the use of remote customer on-boarding solutions</u>, a method that has become increasingly popular with the advances in financial crime technological solutions, and the COVID-19 pandemic

What does the guidance say?

- Firms should ensure policies and procedures are put in place and maintained, providing a general description of the remote tool and how this adequately identifies and verifies customers, the situations in which the remote tool is used, and what steps are fully automated compared to those that require manual intervention.
- Firms should ensure when considering an automated solution, a risk assessment should be conducted pre-implementation assessing the adequacy and completeness of data, and end-to-end testing of the solution.
- Firms should conduct ongoing monitoring on the adequacy and completeness of the automated on-boarding solution.
- The automated solution should enable firms to fully identify natural person(s) and legal entities, as well as identifying the nature and purpose of the relationship.
- Firms should ensure where the automated solution verifies original documents, the firm has taken steps to ensure the verification is reliable. For example, Optical Character Recognition ('OCR') and Machine Readable Zone ('MRZ') verifications are configured adequately, capturing and assessing relevant information.
- Solutions used to verify the identity of individuals identify a clear match between
 the visible information of the natural person and the documentation provided. For
 example, a popular method is for persons to provide a copy of their passport and a
 selfie for facial comparatives to be conducted.
- Where a customer poses greater risks, firms should implement enhanced measures
 to support the automated validation. For example, requiring the first payment on
 the account is processed via a regulated institution, sending a passcode to the
 customer, comparing biometric data, and contacting the customer via phone or
 email.

What have we seen in the market so far?

Through our Economic Crime Advisory client engagements, we have reviewed and assessed a number of automated on-boarding solutions and have identified the following commonly observed areas for enhancement in relation to the systems themselves or within firms' surrounding frameworks:

- Policies and procedures lacking sufficient detail in relation to the configuration of the automated tool and the data contained within.
- Automated solutions not providing firms with the ability to fully understand the nature and purpose of the proposed business relationship. For example, where automated solutions only allow for limited information to be captured during the onboarding process.
- Insufficient ongoing oversight and monitoring of the effective operation of the systems themselves to ensure that they remain adequate and appropriately calibrated in light of the nature, scale, and complexity of firms' businesses.
- Where the system is unable to sufficiently verify a customer's identity and manual intervention is required, the rationale and decision making process for validating documents (i.e., a customer's identification document) is often limited for how the analyst/reviewer can be comfortable the information matches.

► Beneficial Ownership

- The transparency of beneficial ownership has been a continuous point of discussion throughout 2022, specifically the adequacy and appropriateness of registers of persons with significant control.
- The concept of beneficial ownership identification and verification and, by virtue, the methods for enhancing the transparency of such structures is a fundamental component of the fight against economic crime.

► Economic Crime and Corporate Transparency Bill

In September 2022, the Economic Crime and Corporate Transparency Bill was introduced in the House of Commons with aims to deliver:

- Reforms to Companies House;
- · Reforms to prevent the abuse of limited partnerships;
- Additional power to seize and recover suspected criminal cryptoassets;

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- Reforms to give businesses more confidence to share information in order to tackle money laundering and other economic crime;
- New intelligence gathering powers for law enforcement and removal of nugatory burdens on business.

► Financial Action Task Force ('FATF')

- In March 2022, the FATF agreed to immediately start work to update guidance on beneficial ownership with a view to help support the amendments to Recommendation 24.
 In October 2022, FATF published it's draft version of the updated guidance to receive feedback on the updates on the transparency and beneficial ownership of legal persons.
- The updates aim to ensure effective beneficial ownership transparency mechanisms are applied and therefore provide an adequate platform to identify where corporate structures are being used to facilitate financial crime and evading sanctions.

► European Union ('EU') Court Ruling

- In contrast to the efforts made by the UK to improve corporate transparency, and the soon to be issued updated guidance from FATF, the Court of Justice of the EU ("CJEU") ruled that uninhibited public access to beneficial ownership information is not compatible with "fundamental rights."
- The decision concluded by the CJEU noted the provision contained within the EU's Fifth Anti-Money Laundering Directive, requiring nations to establish a public register showing open information on the ownership structure of companies domiciled within the EU are not compatible with the rights to respect for private life and the protection of personal data.

What should Internal Audit teams be thinking about?

Whilst UK firms are not required to comply with EU guidance, the EBA Guidelines nevertheless provide crucial best practice standards which Internal Audit teams should consider.

- Firms Considering an Automated On-boarding Solution: Firms that are considering, or currently in the process of implementing, an automated on-boarding solution should ensure they consider the guidance provided by the EBA. The guidelines provide an appropriate step-by-step guide of the considerations and practical solutions to assess when going through the implementation process.
- Firms with Automated On-boarding Solutions: Firms should assess the appropriateness
 and adequacy of their current automated on-boarding tools, ensuring the guidance
 provided by the EBA is evident within the current tool, and where it is not, firms should
 prioritise remediating the identified issues.

A ROUNDUP FROM THE REGULATORS

REGULATOR	DATE	DOCUMENT	WHAT'S NEW?
HMT	09/12/2022	<u>Policy Paper</u>	UK government's approach to repealing and replacing retained EU law to deliver regulation tailored to the UK
FCA	01/12/2022	<u>Dear CEO letter</u>	Letter to CFD providers regarding FCA's supervisory strategy
PRA	30/11/2022	CP16/22	Consultation for the implementation of the Basel 3.1 standards
FCA	22/11/2022	<u>FS22/1</u>	FCA's feedback statement following discussion on the changing use and value of data in wholesale financial markets
FCA	22/11/2022	<u>Speech</u>	Speech by Sheldon Mills, Executive Director, Consumers and Competition, regarding Diversity, Equity & Inclusion
BoE/HMT/FCA	18/11/2022	Industry Exercise	A two-day UK market wide simulation exercise ("SIMEX 22) to test the UK financial sector's resilience to a major operational disruption
ESMA	17/11/2022	ESMA35-36-2640	MiFID II - ESMA consults on passporting rules for investment firms
PRA	07/11/2022	<u>Dear CRO Letter</u>	Letter to PRA-regulated firms in the asset finance sector which provides a summary of key themes and control weaknesses
FCA	02/11/2022	<u>Speech</u>	FCA's key priorities for the financial advice industry

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