INTERNAL AUDIT SUPPORT

BANKING & BUILDING SOCIETIES UPDATE

November 2022

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BDO FS INTERNAL AUDIT CONTACT POINTS

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

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

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

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ASSURANCE FOR CREDIT RISK AND RESPONSIBLE LENDING

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► Cost of Living Crisis

As the widely termed "Cost of Living Crisis" continues and the UK economy moves closer towards a "profound economic crisis", as noted by the latest Prime Minister, banks, building societies and other lenders are likely to see increased requests for forbearance measures from borrowers, an uptick in the number of their borrowers who default and, accordingly, an upward trend within impairments and provisioning levels.

Unsurprisingly, it is likely that credit risk management and responsible lending arrangements will come under even greater scrutiny from the regulator in the coming months. Lenders will need to continue to monitor the adequacy of their Credit Risk management frameworks, so that they adhere to regulatory requirements, and consider the implications from the incoming Consumer Duty for their responsible lending arrangements.

► What should Internal Audit teams be thinking about?

The incoming Consumer Duty outlines the FCA's expectations on the level of care and customer service to be provided to consumers throughout the product lifecycle. Firms will need to have a greater consideration for supporting customers through the current crisis, as well as keeping alert to vulnerability characteristics within their customer base.

Thinking through the potential impact of the new Consumer Duty, Internal Audit teams within banks and building societies, amongst other regulated lenders, should consider the following questions when planning assurance engagements over the firm's credit risk management and responsible lending controls:

- **Responsible Lending**
  - Is the firm's approach and adherence with Responsible Lending practices clearly documented and appropriate? For example, is sufficient consideration provided for borrowers intending to borrow on repayment terms leading into their retirement period?
  - Are the firm's product terms and conditions clear and fair to consumers?
  - Are consumers aware of the risks of being unable to make repayments as well as the various options available to them if they are struggling to make repayments? Are customer-facing staff sufficiently trained to identify indicators of vulnerability and empowered to handle such cases?
  - Do the firm's affordability calculations adequately incorporate the impact from rising living costs? Where ONS figures are used for affordability calculations, are these up to date and reflective of the forecasted economic situation?
  - Is there an established product governance process in place to revisit lending criteria in light of the changing economic climate? Are credit sanctioning policies and procedures keeping pace with the changes implemented by product governance committees?
- **Risk Appetite and Risk Management**
  - Does the firm's Risk Appetite Statement, including supporting credit risk limits and key risk indicators require revision to take into account any changes in the business strategy and risk tolerance?
  - Does the firm need to revisit the Credit Risk strategy, including consideration of the willingness to grant credit to certain types of exposures, economic sector, and geographical location?
  - Are the firm's lending portfolio sensitivity analyses and stress testing models sufficient to consider more severe, but plausible, stress scenarios and to anticipate the correlated credit risk impact from an economic downturn? For example, how would the firm's real estate exposure fare if pension funds suffer prolonged distress from bond market volatility?
  - Where mortgage books are funded in part from wholesale funds, what consideration has been given to the firm's liquidity mismatch risk and has this been appropriately addressed by the firm's Treasury team?
- **Collections and Recoveries**
  - Does the firm have sufficient resources within arrears management, collections and recoveries departments given the likely increase in the amount of customer contact from those worried about their financial situation and customers seeking alternative repayment options?
  - Is the firm producing the appropriate management information to support the identification of borrowers, or groups of borrowers, exhibiting signs of vulnerability and, therefore, heightened credit risk? Has there been appropriate consideration of how data analytics can help the firm proactively identify geographical and sectoral trends for anticipated collections and recoveries?
  - For lending to commercial borrowers, are the proposed repayment strategies reconsidered as 'feasible' in the worsening economic climate and able to withstand the potential economic downturn?

Credit Risk Management is nothing new; however, the improved use of data to assess geographic and sectoral hotspots, along with effective controls, can help better allocate firm resources for more efficient risk mitigation activities.

CLIMATE CHANGE RISK MANAGEMENT CONTROLS: ARE YOU DOING ENOUGH?

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▶ **Three and a half years after the publication of the Supervisory Statement (SS) 3/19, the PRA expects banks and building societies to be able to demonstrate sufficient embeddedness of climate change risk management controls, as well as strategies to overcome identified barriers.**

The latest letter published by the Bank of England on 21 October 2022 to CEOs of regulated firms provides thematic feedback on their supervision of climate-related financial risk. In the letter, the Prudential Regulation Authority (PRA) reiterates that, by now, all firms in scope of SS3/19 must be able to demonstrate how the PRA requirements are being met.

▶ What was the thematic feedback?

- Firms have made significant progress in embedding its supervisory expectations on governance for climate-related risks. However, **several weaknesses were identified regarding the embeddedness of risk management, scenario analysis, data management and controls related to disclosures**. Boards of those firms that have not made sufficient progress, and do not have a plan to overcome the challenges and progress, should be prepared to explain their position to the regulator.
- Firms need to **reflect on whether Boards have sufficient oversight over the climate change strategy such that they are aware of the progress being made**. Insufficient oversight will compromise the Board and Management's ability to manage the risks and opportunities effectively.
- Other weaknesses were identified in relation to integrating climate risk assessments into the overall risk management framework, risk appetite, committee structures, roles of each of the three lines of defence and utilising scenario analysis results to support effective decision-making, for example, for future revenue projects. **Internal audit functions should support management and the Boards by carrying out reviews of these controls to provide assurance that these are effective from a design and operational effectiveness perspective**.

▶ What is new?

The PRA expects firms to take a step forward after spending the last couple of years enhancing their frameworks given that industry practices have evolved, and new data and tools have become available to firms. Key areas where firms must take steps to remove barriers are governance and oversight, engagement, and data management.

▶ Governance and oversight

- The Designated Senior Manager Function (SMF) for climate change financial risks must be ready to demonstrate how appropriate oversight and control of the firmwide climate agenda has been carried out. This includes ensuring that a resources strategy is in place to make sure that the firm can develop its current climate capabilities and expertise over time.
- From a business strategy and decision-making process perspective, management needs to be able to evidence how the results of scenario analysis have been considered at the time of taking key decisions.
- The Board must be prepared to report on how it has exercised its oversight and challenge responsibilities.

▶ Stakeholder engagement strategy

- Engagement, through stakeholder influences, is a key tool to persuade companies to adopt strategies and increase attention on filling data gaps, as well as to demonstrate a move beyond rhetorical statements to robust strategies and evidence of progress.
- What is evident from the letter is that, where applicable, firms must develop a counterparty engagement strategy to inform them on how their counterparties will look to manage climate exposures, for example, when developing new products and services.
- This will aid firms in their consideration of climate risks within their business strategy and risk appetite.

▶ Data management

- Data availability has been identified as a key barrier to measuring climate risks. However, firms will no longer be able to comfortably say that these challenges have been a barrier to implementing their frameworks.
- The PRA expects firms to set out an approach to identify the gaps, and to have a plan to close those gaps, for which they will need processes to ensure that developments in data and tools will be identified and incorporated into their approach.
- Where data gaps exist, all firms should have contingency solutions in place using appropriately conservative assumptions, judgements, and proxies. Firms should, by now, be increasingly focused on bolstering quantitative data availability going forward.

A NEW CORPORATE GOVERNANCE CODE

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► Background

Governance and Board Effectiveness has been an increased are of focus and scrutiny for regulators in recent years. The Financial Reporting Council ("FRC") has recently published its Position Paper, "Restoring Trust in Audit and Corporate Governance", that outlines its next steps towards strengthening the Audit and Corporate Governance framework within UK audit and corporate firms.

The Paper follows on from the Government's Response to the consultation on enhancing the UK's Corporate Governance, Corporate Reporting and Audit Systems.

► A revised Corporate Governance Code

The FRC has noted that it intends for the revised Corporate Governance Code ("CGC") to be implemented from "periods commencing on or after 1 January 2024" and will consult on the Code and supporting material from Q1 2023.

As such, it is appropriate that Internal Audit teams within affected firms start to consider the implications of the revised Code and plan accordingly.

Firms that fall under the FCA Listing Rules must adhere to the Code as a requirement and will, therefore, have to adhere to the proposed changes by 1 January 2024. Other financial services firms may chose to adhere to the CGC requirements and guidance as a means of best practice.

► What are the key new changes and requirements?

The CGC will remain principle-based and flexible, but the key enhancements will include:

- The need for a framework of "prudent and effective controls to provide a more stronger basis for reporting on and evidencing the effectiveness of internal controls" for end of year reporting;
- Revisions to "the wider responsibilities of the Board and Audit Committee for expanded Sustainability and ESG reporting" including the requirement for improved assurance in this area;
- To enhance existing CGC provisions where reporting is "weaker" as outlined in the FRC's Creating Positive Culture report (December 2021);
- Adding a provision for boards to consider how the audit tendering process addresses the need to expand market diversity in audit services; and
- **The need for post-implementation governance internal audit reviews to provide assurance that the revised Corporate Governance Code has been adequately implemented.**

► What should Internal Audit teams be thinking about?

The proposed changes cover a broad spectrum of governance arrangements and, as such, it may be beneficial for Internal Audit teams to consider the impact of the CGC as part of evaluating the firm's overall governance structure per Performance Standard 2110 (Governance).

Governance arrangements are expected to be appropriate for the "*nature, size and complexity*" of a firm's activities and business model (FCA Handbook, SYSC 3.1.1R). This can often be an elusive term, but key considerations for Internal Audit teams include:

- Are all governance arrangements clearly documented so that employees could outline the relevant reporting lines if questioned?
- Does the firm's current suite of governance documentation, including organisational charts, Management Responsibilities Maps ("MRM"), role and responsibilities descriptions and committee/board Terms of Reference ("TORs"), reflect the current allocation of responsibilities and approval processes currently in practice?
- Are there any potential conflicts of interest or "bottlenecks" within the current governance structure? For example, a lack of independent challenge within key control areas such as Risk and Compliance, remuneration and incentive arrangements or strategic business decisions?
- Are there any "key person risks" where sufficient resilience arrangements and succession planning have not been implemented?

► Governance controls – design adequacy vs. operating effectiveness

In addition, whilst control processes, such as organisational structures, may appear to conform with established policies and procedures, this does not necessarily mean that they are operating effectively – i.e., control design may be adequate, but controls may not be operating effectively.

As such, whilst assessing the design of governance arrangements and the underlying framework, internal audit teams should consider conducting effectiveness assessments. These assessments may be in the form of:

- board effectiveness reviews;
- testing of the reporting and escalation mechanisms;
- gaining insights from employees around key issues, e.g. firm culture surveys.

ECONOMIC CRIME UPDATE
FCA MARKETWATCH 70: TRANSACTION REPORTING

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► FCA Market Watch 70

- On 3 October 2022, the FCA published its latest Market Watch newsletter in which it summarised its recent observations from its supervisory engagements with MiFID-compliant firms.
- This periodic newsletter, and summary of the FCA's findings, is relevant for credit institutions who undertake investment activities and services in respect of financial instruments, such as bonds, traded through a regulated trading venue.
- The main areas of focus within Market Watch 70 are summarised below.

► Transaction Reporting

Transaction Reporting from MiFID compliant firms is a key tool for the FCA to detect, investigate and prevent market abuse; therefore, the quality of data underlying a firm's transaction reporting is of critical importance. Firms' regular use of the FCA's Market Data Processor (MDP), to facilitate reporting, is a requirement within the regulatory technical standards (RTS 22). Key issues recently identified by the FCA include:

- Firms not conducting sufficient checks on the data underlying their transaction reporting, i.e., the volume of MDP use for reporting purposes has increased steadily since MiFID II was implemented, but the volume of breach notifications has kept almost stagnant;
- The variable levels of information included in the breach notifications. Reporting firms in some cases have provided limited details and unhelpful references to proprietary reporting systems or processes.

► National Identifiers

National Identifiers, to confirm the nationality of natural persons in transaction reports, is an obligation and all national identifiers can be found within Annex II of RTS 22. Despite repeated warnings from the FCA, firms have been found failing to conduct sufficient due diligence when onboarding clients to obtain the relevant national identifiers.

The issue is 'particularly common' amongst firms offering services to retail clients electronically, such as via mobile-based applications.

► Principal Firms (Appointed Representatives being identified in reports)

The FCA have highlighted confusion from Appointed Representatives (AR) being identified in transaction reports. For transaction reporting purposes, the FCA view an AR as its principal firm. This means that when a transaction is executed by an AR providing the investment service for a principal firm that is subject to transaction reporting obligations, the principal firm should be identified, not the AR.

► Systems and Controls

The FCA also re-emphasised its expectations for the systems and controls of trading venues and systemic internalisers (SI):

- **Identification of issues**: trading venues and SIs should have arrangements in place to enable them to identify incomplete or inaccurate instrument reference data. These arrangements are required by Article 6(2) of RTS 23.
- **Review of MDP feedback**: trading venues and SIs should ensure they have procedures in place to review feedback files, including any warning messages received, which notify the submitting entity that its record differs from the master record used to validate transaction reports. These procedures should include investigating why records or files have been rejected. Submitting entities should not amend their reference data to match the master record without first confirming its accuracy.
- **Regulatory reporting**: where a trading venue or SI identifies incomplete or inaccurate instrument reference data in its submissions, the FCA expects to be notified promptly through the submission of an instrument reference data errors and omission notification form.

► What should Internal Audit teams be thinking about?

- **Risk Assessments:** the quality, and overall clarity, of information submitted to the FCA appears to be a significant risk. Risk mitigation activities should include sufficient oversight over the production, review and submission of transaction data, as well as regular testing of high-risk processes such as breach notifications. Regularly challenge your regulatory reporting teams to the reasonableness test: "would our reporting make sense to a reasonably informed person outside of our walls?"
- **Policies and procedures:** are these clear and up to date with FCA's Market Watch findings? What system of staff training is in place to ensure transaction reporting policies and procedures are understood, followed and its compliance monitored such that any deviations to controls are flagged as soon as possible? Inappropriate risk assessments of reporting processes tend to focus disproportionately on the IT / platform issues (especially given the quantifiable monetary impact to the firm's resources); however, often, the root cause stems from staff being under-trained, under-resourced or mismanaged to properly fulfil reporting processes (i.e. operating effectiveness tends to trump design adequacy as the key issue).
- **Outsourced reporting activities:** issues driven by third-party service providers remain the accountability of the firm and outsourced regulatory reporting, wherever applicable, should feature as a high-risk area within the audit plan.

A ROUNDUP FROM THE REGULATORS

REGULATOR	DATE	DOCUMENT	WHAT'S NEW?
FCA	25/10/2022	CP22/20	FCA consultation regarding Sustainability Disclosure Requirements (SDR) and investment labels
PRA	21/10/2022	Dear CEO letter	Thematic feedback on the PRA's supervision of climate related financial risk and the CBES exercise
BoE	19/10/2022	Speech	"Decentralised" Finance: Get up, Stand up! Carolyn Wilkins, FPC, encourages the crypto industry to build best practices in governance, codes of conduct, and set high expectations for transparency
FCA	14/10/2022	Update	An update from the FCA to address Consumer Duty related queries received from in-scope firms
PRA	12/10/2022	CP12/22	Proposals to better manage the risks from contingent leverage which will affect the ICAAP and future reporting of leverage
FCA/PRA/BoE	11/10/2022	DP5/22	Discussion paper from the Regulators to consider the challenges associated with the use and regulation of Artificial Intelligence
FCA	06/10/2022	Dear CEO letter	FCA's view on how high-cost lending products pose harm to customers and markets
FCA	03/10/2022	CP22/19	Creation of a baseline financial resilience regulatory return relevant for FCA-solo regulated firms
FCA	03/10/2022	Market Watch 70	FCA's most recent observations on the transaction reporting and instrument reference data regimes

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