FRTB: Better Get Your Skates On

Also in this issue
- Innovative Bank Internal Audit
- Outsourcing EBA-Style
- Is Artificial Intelligence the future of Risk Management?
- The New Product Intervention and Product Guidance Rules (PROD)
- Rebuilding Confidence in the Financial Services

© Risk Reward Ltd UK. All rights reserved. Available by subscription only – not for sale or resale
Innovative Bank Internal Audit

Dennis Cox FCA, CEO of Risk Reward Ltd, talks about its principles, approaches, implementation, reporting & why its just more fun

Internal audit has been changing for many years, from an inspection function looking for errors to an increasingly risk-based function seeking to add value. This development has been at best uneven and has overlapped with a number of other key initiatives. These include:

- The development of standards for internal audit in banks by the Bank for International Settlements (BIS)
- Increasing complexity including model usage
- Developing risk management and internal control functions increasing the scope of the second line of defence
- Developing model validation units in accordance with rules and regulations
- An increased focus on stress testing and scenario modelling

All of this has provided challenges for internal audit and an innovative function will both grab these opportunities and seek to add greater value to their firm.

Implementing Innovative Bank Internal Audit

One of the biggest challenges for internal audit is to move from being the unit that criticises people for making mistakes to becoming a unit that adds value through innovative internal audit techniques.

Not all losses are issues for internal audit. If management designs an approach anticipating a level of losses as a consequence, the existence of these losses is hardly an issue for internal audit. It is only if there is a divergence in loss incidence from the historic norms that this will come into play.

As an internal auditor you can never change the past. Mistakes will have been made and investigated by the second line of defence (either internal control, management or risk management, or a combination of the three). This is not a role of an innovative internal audit function which is instead focussed on designing efficient and effective controls that lead to a loss profile.
consistent with management's expectations. This auditing to future approach focussing on preventative controls and leading indicators lies at the heart of innovative internal audit.

Approaches to Adopt

Innovative bank internal audit adds value to the business. It seeking to think through the nature of the control environment and identify areas where improvements and changes can be made successfully. It is a collaborative function which improves profitability or goal congruence. While providing input into the design and implementation of controls and processes it will always focus on the bigger issues regardless of the politics that go with them, avoiding what might be referred to as career limiting audit findings.

It thinks more about the planning and approaches to be adopted. The walkthrough is no longer just checking that the business is conducted in accordance with policies and procedures. Rather it now considers the control and process approach being adopted and seeks to identify how this could be made more efficient and effective. It is often in resolving the efficiency decision where the greatest values could be added.

The risk-based approach is always about doing more of what adds greatest value reducing work in other areas. Through careful planning and consideration of the overlap of audits a much more efficient approach to audit can be achieved.

Data Mining and Techniques

Increasingly the expectation is that internal audit will identify both fraud and money laundering activities within business units. Internal audit needs to maintain healthy scepticism regarding the likelihood that staff are acting in accordance with ethical standards. They also need to utilise modelling techniques to assist them in obtaining the level of assurance that they need for their purposes. Such data mining techniques need to be applied in those areas which are most susceptible to inappropriate activity being conducted and where the greatest impact on the business could occur.

Internal audit needs to ensure that such findings are delivered in a way that management can easily synthesise. Innovative internal audit if always focussed on delivery outcomes and change since without change our role becomes pointless. Indeed, working with management to identify solutions to the problems raised lies at the heart of the approach to be adopted. This is not about conflict or them and us. We are all part of the same protective story aiming to ensure that management can sleep more comfortably at night. Comfortable in the knowledge that the control framework meets the demands of the governance framework and ensures achievement of goals and missions.

Risk- Based Internal Audit

The application of risk-based internal audit is essentially mandatory for bank internal auditors within the statements issues by the Bank for International Settlements. This needs to be based upon the risk appetite statement agreed by management and embedded within the business through both correlation of risk modelling and cascading risk to the level of the control.

At a unitary level if a failure of a control could lead to a unitary risk appetite being breached then this becomes a high-risk issue by definition. This is no longer open to discussion. The risk registers that are used by internal audit are maintained within the business under the guidance of risk
management. These are audited by internal audit but are not replaced or replicated. By providing clarity on this the arguments that may have ensued are no longer relevant.

Risk-based internal audit ensures that internal audit focuses on the big issues, auditing through the control function and identifies areas where value can be added through improving systems and controls. This could even mean removing controls which are no longer cost effective, something many internal audit functions finds difficult to consider.

Innovative Internal Audit Reporting

The innovative internal audit report is easy to read and clearly leads to action. It is the key delivery product for the audit function and is provided to different audiences each requiring different delivery. This takes planning and design to achieve. It should be an interesting document where the time of hard-pressed senior management is not wasted ploughing through oceans of irrelevance to identify matters of substance. Through copious use of annexes and the inclusion of matters from other audit reports relevant to the reader a greater auditee fairness if achieved.

It is positive, including colour and design and incorporating illustrations where necessary to enable the reader to appreciate the importance of the issue raised. Too many good audits are ruined by poor delivery.

Conclusion

Innovative internal audit is a change-in-thinking approach. It is more enjoyable for both the auditor and the auditee and adds greater value to the institution.

Proper training can support learning needed as to what this means in greater detail and how auditors can move your audit function to take advantage of the opportunities that present themselves.

For more information please click here.

Dennis Cox BSc FCA FCSI
Chief Executive Officer, Risk Reward Ltd